WPC – Committee to Review the Structure of Securities Regulation in Canada

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Research Studies

Edited by

A. Douglas Harris

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Foreword

The debate regarding securities regulatory structure in Canada typically has not been informed by robust empirical analysis and has suffered from a lack of current data on its central issues.

Therefore I was pleased to be appointed on behalf of the Capital Markets Institute as the Research Director for the WPC Committee to Review the Structure of Securities Regulation in Canada, to implement the Committee's research program. I believe that the debate on Canada's securities regulatory structure will be enhanced by the research studies published with the Report of the Committee. They represent comprehensive and rigorous new work by respected independent academics and consulting firms from Canada, the United States, Australia and the European Union. In addition to their consideration of numerous public submissions and extensive public consultations, the Committee's Report reflects its members' careful consideration of the researchers' analysis and conclusions.

This research could not have been completed in a remarkably compressed timeframe without the Committee's support of its research program. More obviously, these studies could not have been produced without the dedication and sacrifice of the researchers. Each of them undertook their work with enthusiasm and diligence in spite of conflicting personal and professional demands. The body of research is a testament to their individual commitment to advancing our collective knowledge relating to Canadian capital markets.

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WPC – Committee to Review the Structure of Securities Regulation in Canada

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November 10, 2003

Michael Phelps, Chair
Wise Persons' Committee
Committee to Review the Structure of Securities Regulation in Canada
25th Floor
700 West Georgia Street
Vancouver, B.C.
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Dear Mr. Phelps:

RE: Constitutional Opinion Concerning the Canadian Securities Commission Model

You requested our opinion concerning the constitutional validity of federal and provincial[1] legislation implementing the Canadian Securities Commission ("**CSC**") model proposed by the Wise Persons' Committee.

Under the CSC model, Parliament would enact the Canadian Securities Act ("**Act**") based on the uniform securities legislation developed by the Canadian Securities Administrators and endorsed by the provinces. The Act would provide for comprehensive capital market regulation across Canada.

The provinces would pass legislation incorporating the Act by reference. If a majority of the provinces representing a majority of the population object, amendments to the federal legislation would not be implemented.

The Act would be administered by the CSC, a federally constituted commission having policy-making, administrative, enforcement and judicial functions. The CSC would operate through a head office and regional and district offices. The provinces would dissolve their existing securities regulators and delegate administrative powers to the CSC.

While the Commissioners would be appointed by the federal Minister of Finance, the provinces would be significantly involved in the selection process. The composition of the CSC would reflect regional diversity. A committee of provincial and federal ministers responsible for

[1] Unless otherwise indicated, references to "provinces" and "provincial" in this opinion letter include references to "territories" and "territorial".

securities regulation would provide policy and administrative oversight and input, including the consideration of legislative amendments.

Issues

You asked us the following questions:

1. Does Parliament have constitutional authority to enact the Act?

2. Do the provinces have constitutional authority to enact legislation: (a) incorporating the Act by reference; (b) delegating administrative powers to the CSC; and (c) dissolving their existing securities regulators?

3. If one or more provinces decide not to enact such legislation, and if the federal government concludes that this would jeopardize the successful operation of the scheme in other parts of the country, would Parliament have the constitutional authority to include an express paramountcy clause in the Act?

Summary of Conclusions

For the reasons set out below, our responses are as follows:

1. In our view, Parliament has the constitutional power to enact the Act. The general branch of the federal trade and commerce power under section 91(2) of *The Constitution Act, 1867* ("**Constitution Act**") provides Parliament with the strongest basis for enacting the Act.

2. In our view, the provinces have constitutional authority to enact legislation: (a) incorporating the Act by reference; (b) delegating administrative powers to the CSC; and (c) dissolving their existing securities regulators.

3. In our view Parliament could validly enact an express paramountcy clause that precludes provincial securities laws in their entirety. We acknowledge, however, that there is no binding precedent in the case law supporting the validity of such a clause.

We address each question below.

Discussion

1. **Does Parliament have the constitutional authority to enact the Act?**

In our view, Parliament has the constitutional power to enact the Act. The federal trade and commerce power under section 91(2) of the Constitution Act provides Parliament with the strongest basis for enacting the Act. The federal trade and commerce power has two branches: the general branch and the interprovincial and international branch. In our view, the more effective basis for the Act would be the general branch because it more clearly authorizes a comprehensive securities regime.

The criminal law power under section 91(27) of the Constitution Act also could support certain aspects of the Act. Other heads of constitutional power provide somewhat weaker support for the validity of the Act. These include the national concern branch of the peace, order and good government ("POGG") power (opening words of section 91), the federal power over works and undertakings (section 92(10)(a)), and, if exercised, the federal power to declare works to be for the general advantage of Canada (section 92(10)(c)).

We discuss each of these federal powers below.

a. General Trade and Commerce Power

In our view, the general branch of the trade and commerce power under section 91(2) of the Constitution Act provides Parliament with a strong basis for enacting the Act.

Chief Justice Dickson, writing for the Supreme Court of Canada in *General Motors v. City National Leasing*,[2] summarized five indicia of valid federal legislation under the general branch of the trade and commerce power. The list is neither exhaustive nor determinative, but the presence of the five factors makes it more likely that federal legislation validly addresses a matter of genuine national concern. In our view, all five factors would be present in the Act:

i. The legislation contains a general regulatory scheme

The Act clearly would contain a general scheme regulating Canadian securities markets. It would provide for the regulation of primary and secondary capital markets for equity and debt securities, the oversight of self-regulatory organizations ("**SROs**"), civil remedies and criminal sanctions to enforce the regulatory scheme, and international securities agreements. The scheme would primarily be administered through the imposition of disclosure, registration and licensing requirements on the issuers and intermediaries participating in Canadian capital markets.

ii. The scheme is monitored by the continuing oversight of a regulatory agency

The CSC would be a regulatory agency with continuing oversight of the scheme contained in the Act. It would exercise administrative, enforcement and judicial powers to ensure compliance with the Act.

iii. The scheme is concerned with trade as a whole, and not with a particular industry

In our view, the Act would not regulate a "particular industry" as that concept is understood in the context of the general trade and commerce power. It would extend to a complex web of relationships and activities. It would regulate a broad range of market participants including reporting issuers, investors, investment managers, market intermediaries, stock exchanges, clearing and settlement organizations and SROs. It would apply to a broad range of economic activities including the issuance, trading, settling and clearing of equities, bonds, money market

[2] [1989] 1 S.C.R. 641.

securities, commercial paper, and derivatives. Rather than being directed at a "particular industry", the Act would be directed at facilitating the efficient flow of capital and the effective functioning of the Canadian capital markets.

The rationale for the "particular industry" restriction is to prevent the use of the general trade and commerce power to support federal legislation concerning an activity that is essentially a collection of local concerns. Instead, the activity must genuinely be of national economic concern. There is strong evidence that the operation of Canada's capital markets has become a matter of national economic concern. Regulators are dealing with multinational groups operating across borders and conducting transactions involving parties in many jurisdictions and complex new products. Canada's exchanges have been consolidated on a national basis. The clearing, settlement and payment systems provide an integrated infrastructure that supports trading activity on a national basis. Derivative and other exchange and trading systems operate nationally and internationally. Issuers with a market capitalization over $75 million account for an estimated 98% of total market capitalization in Canada. Almost all of these issuers are reporting issuers in all ten provinces and some also report in the territories. Other market participants, including the brokerage industry and SROs, also operate on a national basis.[3]

iv. The legislation is of a nature that the provinces jointly or severally would be constitutionally incapable of enacting

The provinces, through cooperative efforts, have attempted to "jointly or severally" enact and enforce uniform securities legislation.[4] However, the Act would exceed the scope of any collective scheme the provinces are capable of implementing:

- Although the legislation of each province can have an "incidental" extraprovincial effect, it cannot validly be aimed at transactions having no connecting factors at all with the province. By contrast, the Act could regulate all trades in securities, whether intraprovincial, interprovincial or international, having any connecting factor with Canada.

- The provinces have subscribed to the goal of creating an efficient, effective and competitive system of securities regulation in Canada through the enactment of uniform provincial securities laws. While the provinces are constitutionally capable of enacting uniform securities laws, they cannot compel each other to do so. Nor can they validly prevent each other from enacting provincial legislation that deviates from the uniform scheme. Only Parliament can enact a single

[3] We have relied on the data contained in Chapter One of the WPC Report without independent verification.

[4] For example, the Canadian Securities Administrators have taken numerous initiatives, including entering into memoranda of understanding relating to MRRS and the oversight of stock exchanges, devising a system to streamline registration of securities representatives, adopting national instruments and other texts of national scope and embarking on the uniform securities laws project. See Suret, J.M. and Carpentier, C. at CIRANO, "Securities Regulation in Canada", Working Paper for the Commission des valeurs mobilières du Québec at 24-32 (July 29, 2003).

legislative scheme that ensures the uniformity of securities regulation throughout Canada.

- Similarly, while the provinces can undertake to reciprocally enforce each other's securities laws, they cannot validly compel such cooperation. If a province withheld cooperation, other provinces could not unilaterally enforce their legislation beyond their territorial boundaries. Only Parliament can require the uniform enforcement of its legislative scheme throughout Canada.

v. If one or more provinces were excluded from the legislative scheme, the exclusion would jeopardize the successful operation of the scheme elsewhere in Canada

If one or more provinces opted out of the federal CSC model, the failure of any province to effectively regulate its securities market would jeopardize the efficiency and integrity of the Canadian securities markets and the protection of the investing public. If the excluded provinces enacted comparable provincial securities legislation, comprehensive national securities regulation could be achievable. However, the remaining provinces could not compel the excluded provinces to enact such legislation. Nor could they prevent the excluded provinces from repealing the legislation. Accordingly, the successful operation of the CSC model throughout Canada requires federal securities legislation.

b. Interprovincial and International Trade and Commerce Power

The interprovincial and international branch of the trade and commerce power would support the validity of certain aspects of the Act relating to interprovincial and international securities transactions. The Supreme Court of Canada has signalled its willingness to consider this branch of the federal trade and commerce power as a basis for valid federal securities legislation.[5]

The interprovincial and international branch of the federal trade and commerce power may even support the Act in its entirety, including provisions that regulate intraprovincial transactions. Arguably the Act could be characterized as a regulatory scheme directed at interprovincial and international capital markets that has an incidental impact on local markets. An analogy may be drawn between the Act and the legislation at issue in *Caloil v. A.-G. Canada.*[6] In that case, the Supreme Court of Canada allowed Parliament to regulate oil transactions within a province where a regulatory scheme was aimed at interprovincial and international trade and required such regulation to function effectively.

[5] *Multiple Access Ltd. v. McCutcheon*, [1982] 2 S.C.R. 161 at p. 173, *obiter* comment in majority judgment by Dickson J. (as he then was): "I should not wish by anything said in this case to affect prejudicially the constitutional right of Parliament to enact a general scheme of securities legislation pursuant to its power to make laws in relation to interprovincial and export trade and commerce. This is of particular significance considering the interprovincial and indeed the international character of the securities industry."

[6] [1971] S.C.R. 543.

However, the scope of legislation authorized by this branch is uncertain because of early marketing cases decided by the Privy Council and, more recently, by the Supreme Court of Canada. The Privy Council held that where marketing legislation directly regulated transactions that could be completed within a province, it was invalid because Parliament could not directly control the local production or marketing of a product.[7] In *Dominion Stores v. The Queen*[8] and *Labatt Breweries v. A.-G. Canada*,[9] the Supreme Court of Canada rejected Parliament's attempts to rely on the interprovincial and international trade and commerce power as support for federal marketing legislation affecting local matters.

In light of this case law, the scope of the Act supported by the interprovincial and international branch of the federal trade and commerce power is uncertain. The general branch, on the other hand, supports federal power over all aspects of securities regulation. Accordingly, the general branch is the more certain source of power for the entire Act.

c. Criminal Law Power

Parliament has the power to legislate with respect to criminal law pursuant to section 91(27) of the Constitution Act. The criminal law power would support certain aspects of the Act, but likely would not support the full regulatory scheme. The investigative and enforcement aspects of the Act clearly would fall within the criminal law power. Arguably regulatory measures backed by penalties, such as the imposition of disclosure, registration, licensing and self-regulation requirements, also could be justified as having a criminal law purpose.[10] However, the comprehensive scope of the Act may tip the balance and result in a finding that the Act has a predominantly regulatory, rather than criminal law, purpose. The creation of investors' civil rights of action and issuers' liability in damages for fraud and misrepresentation likely would fall outside the criminal law power.

d. National Concern Branch of POGG

In order for the national concern branch of POGG to apply,[11] the subject matter of legislation must have become a concern for Canada as a whole. In our view, the Act would meet this initial hurdle of regulating a matter of national concern.

For the reasons set out above in our discussion of the general trade and commerce power,[12] the Act also would meet the criterion that the provinces are incapable of regulating the matter.[13]

[7] See for example, in *British Columbia (A.G.) v. Canada (A.G.)*, [1937] A.C. 377.

[8] [1980] 1 S.C.R. 844.

[9] [1980] 1 S.C.R. 594.

[10] See, for example, *R. v. Hydro Quebec*, [1997] 3 S.C.R. 213; *Reference re: Firearms Act (Can.)*, [2000] 1 S.C.R. 783.

[11] See the opening words of section 91 of the Constitution Act.

[12] See heading 1(a)(iv) above.

[13] *R. v. Crown Zellerbach Canada Ltd.*, [1988] 1 S.C.R. 401.

However, the national concern branch of POGG provides a relatively weak basis for enacting the Act. The Supreme Court of Canada has observed that the national concern branch potentially could justify interference with all provincial powers and thus upset the distribution of powers under the Constitution Act.[14] For this reason, the Court has imposed certain additional limits:

- Newness: The Court is more likely to find that "new" matters fall within this branch of POGG because the federal regulation of such matters is less likely to interfere with provincial legislative powers. Securities trading is not a new matter, and courts have long allocated it to provincial jurisdiction. This factor reduces the likelihood of the Act being upheld under the national concern branch of POGG.
- Singleness, indivisibility and distinctiveness: In order to fall within this branch of POGG, a matter must be sufficiently "single", "indivisible" and "distinct" that its regulation would not unduly disturb the constitutional distribution of powers. The most problematic of these limits is the "distinctiveness" requirement. The very factors that support the general branch of the trade and commerce power weaken the argument that capital markets regulation is sufficiently distinct. The broad scope of the Act would intrude on powers traditionally exercised by the provincial legislatures.[15]

For these reasons, in our view, there remains some uncertainty that the Act can be supported under the national concern branch of POGG.

e. Federal Works and Undertakings

Another potential basis for the Act would be the federal power to enact legislation in relation to interprovincial works and undertakings pursuant to section 92(10)(a) of the Constitution Act. The courts have restricted the exercise of this power to interprovincial transportation and communications and analogous activities.[16] To the extent the Act relates to the use of computerized securities exchange and clearing and settlement networks, an analogy could be drawn between the subject matter of the Act and "transportation" and "communications".[17] This argument is creative and potentially could have far-reaching implications for the division of powers under the Constitution Act. The Court would take these implications into account in weighing the merits of the argument. In our view, the Court is more likely to be persuaded by arguments under the federal trade and commerce power which are based on a more principled approach.

[14] *Reference re Anti-Inflation Act*, [1976] 2 S.C.R. 373.

[15] *R. v. Crown Zellerbach Canada Ltd.*, *supra* at pp. 432-433.

[16] McNairn, *Transportation, Communication and the Constitution, The Scope of Federal Jurisdiction* (1969), 47 Can. B. R. 355.

[17] See, for example, the argument of Anisman and Hogg in *Constitutional Aspects of Federal Securities Legislation*, Sept. 1978, at p. 172.

Section 92(10)(c) of the Constitution Act gives Parliament the power to declare "works" to be for the general advantage of Canada. Works are physical things rather than pure services and include the undertakings associated with those physical things.[18] Computerized facilities for effecting, clearing and settling securities transactions in Canada arguably constitute works.[19] If Parliament, in enacting the Act, declared capital market facilities to be works for the general advantage of Canada, the Act might be upheld as a valid exercise of the declaratory power. The exercise of the declaratory power, if valid, would extend to the regulation of participants and activities associated with these facilities, but would not apply to over-the-counter trades.

The declaratory power has been criticized as inconsistent with classical principles of federalism and has fallen into disuse.[20] Parliament's use of the declaratory power can significantly intrude on provincial property and civil rights. In light of the far-reaching impact of the declaratory power, we believe that the Court likely would take a cautious approach to the argument that computerized capital market facilities are sufficiently tangible to constitute "works".[21]

2. **Do the provinces have constitutional authority to enact legislation: (a) incorporating the Act by reference; (b) delegating administrative powers to the CSC; and (c) dissolving their existing securities regulators?**

a. Incorporation by reference

Parliament cannot delegate its legislative powers to the provincial legislatures. Such a delegation would expand the constitutional powers of the provinces and disturb the division of powers in the Constitution Act.[22]

However, provinces may enact provincial legislation that incorporates federal legislation by reference, provided the incorporated legislation falls within the provinces' constitutional power. Such an incorporation by reference is not considered to be delegation. Instead, it is an exercise of the provinces' valid law-making power.[23]

[18] *Ontario Hydro v. The Ontario Labour Relations Board,* [1993] 3 S.C.R. 327.

[19] See articulation of this argument in Anisman and Hogg, *supra,* p. 175.

[20] Hogg, P.W., *Constitutional Law of Canada*, 4th ed. (Toronto: Carswell, 1997+) at section 22.8; Monahan, P., *Constitutional Law*, 2nd ed. (Toronto: Irwin Law, 2002) at 368. Although the declaratory power was used on hundreds of occasions in the late nineteenth and early twentieth centuries, in the past 35 years it has been resorted to twice in very narrow circumstances: The *Cape Breton Development Corporation Act*, S.C. 1967-68, c.6; and the *Teleglobe Canada Reorganization and Divestiture Act*, S.C. 1987, c. 12.

[21] Leckey and Ward are of the view that the current securities markets likely would not have a sufficient physical presence to constitute a "work": "Taking Stock: Securities Markets and the Division of Powers" (1999), 22 Dalhousie L.J. 250.

[22] *Nova Scotia (A.G.) v. Canada (A.G.) (Nova Scotia Inter-delegation)*, [1951] S.C.R. 31.

[23] See *Coughlin v. Ontario (Highway Transport Board),* [1968] S.C.R. 569, which provides an example of federal legislation that incorporated provincial legislation by reference.

The provinces' constitutional power to enact comprehensive securities legislation is uncontroversial, even where that legislation has a significant impact outside the province.[24] Accordingly, each province could enact valid legislation incorporating the Act by reference with respect to all matters having a connecting factor with the province.

The Act would impose a process for federal and provincial consultation and cooperation as a condition precedent to amending the legislation. The provinces, in addition to having the right to be consulted, would have certain powers to veto substantive legislative amendments. We anticipate that the substantive elements of the CSC model would be contained in subordinate legislation such as regulations, rules, instruments and policy statements. While Parliament cannot fetter its own discretion to amend the Act,[25] it can validly impose limits on the amendment of subordinate legislation made under the Act.[26]

b. Delegation of administrative powers to the CSC

Provinces clearly have the constitutional power to delegate to the CSC all administrative powers falling within their jurisdiction over the regulation of securities. Therefore, they could delegate all the administrative powers currently exercised by the provincial securities regulators. The delegation must not amount to an abdication, however. The provinces must retain the ultimate power to amend or revoke the delegation.[27]

c. Dissolution of existing provincial securities regulators

Provincial securities commissions may be dissolved by provincial legislation. To the extent that natural persons, such as government officials, have regulatory authority over securities, the provinces may revoke their administrative powers.

[24] Mainly pursuant to the provinces' power to enact legislation concerning property and civil rights within the province under section 92(13) of the Constitution Act. See, for example, *Gregory & Company Inc. v. QSC,* [1961] S.C.R. 584; *R. v. W. McKenzie Securities Ltd.* (1966), 56 D.L.R. (2d) 56 (Man. C.A.), leave to appeal denied [1966] S.C.R. 9; *Quebec v. OSC* (1992), 10 O.R. (3d) 577 (C.A.)., leave to appeal denied (S.C.C. Bulletin, 1993, p. 1077), implicitly confirmed by the S.C.C. in *Committee for the Equal Treatment of Asbestos Minority Shareholders v. OSC,* 2001 S.C.C. 37; *British Columbia Securities Commission v. Global Securities Corporation*, [2000] 1 S.C.R. 494.

[25] *Attorney General of British Columbia v. Esquimalt and Nanaimo R. Co.,* [1950] 1 D.L.R. 305 (P.C.); *Re Canada Assistance Plan,* [1991] 2 S.C.R. 525.

[26] See, for example, section 22(2) of the *Canada Health Act*, which states: "… [N]o regulation may be made under paragraph (1)(a) or (b) except with the agreement of each of the provinces"; section 22(4) of the *Canada Health Act*: "No regulation may be made under paragraph (1)(c) or (d) unless the Minister has first consulted with the ministers responsible for health care in the provinces"; and section 53(2) of the *Canada Pension Plan Investment Board Act*, "A regulation made under subsection (1) has no force or effect until the appropriate provincial Minister of each of at least two thirds of the participating provinces having in total not less than two thirds of the population of all of the participating provinces has approved the regulation".

[27] *Shannon v. Lower Mainland Dairy Products Board*, [1938] A.C. 708.

3. If one or more provinces decides not to enact such legislation, and if the federal government concludes that this would jeopardize the successful operation of the scheme in other parts of the country, would Parliament have the constitutional authority to include an express paramountcy clause in the Act?

The paramountcy doctrine applies where constitutionally valid provincial laws and constitutionally valid federal laws come into conflict. Under the paramountcy doctrine, the federal law prevails and the provincial law is rendered inoperative to the extent of the conflict.[28]

The Supreme Court of Canada has held that the paramountcy doctrine applies only where the conflict is irreconcilable, so that compliance with one statute constitutes breach of the other.[29] In recent decisions, the Court has expanded the notion of irreconcilable conflict and has applied the paramountcy doctrine where provincial legislation defeats Parliament's legislative purpose.[30]

In our view, the enactment of an express paramountcy clause could create an irreconcilable conflict that precludes provincial laws. Professor Peter Hogg, in his leading text on constitutional law, states that an express paramountcy provision should be valid so long as it is contained in an otherwise valid federal law.[31] We share Hogg's view. In the face of such an express paramountcy clause, the continued application of a provincial law precluded by the clause would defeat Parliament's legislative purpose.

As noted above, in our view the Act falls within Parliament's constitutional power and so the express paramountcy clause would be contained in an otherwise valid federal law. Further, the paramountcy clause itself would serve the valid federal objective of preventing provinces from opting out and jeopardizing the successful operation of the CSC model throughout Canada.[32] Accordingly, in our view Parliament could validly enact an express paramountcy clause that precludes provincial securities laws in their entirety.

There is no binding precedent in the case law indicating how the Supreme Court of Canada would view a Parliamentary statement of express paramountcy. While we are of the view that such a clause would validly exclude provincial securities legislation, we acknowledge that it would test the limits of Parliament's power to oust the valid exercise of provincial powers simply by stating such a purpose in the Act.

In closing, we note that the federal government's adoption of the Act, including the enactment of an express paramountcy clause, would be a novel initiative. You may wish to consider the

[28] *Multiple Access, supra*

[29] *Ibid.*

[30] *Bank of Montreal v. Hall*, [1990] 1 S.C.R. 121; *Law Society of British Columbia v. Mangat*, [2001] 3 S.C.R. 113

[31] Hogg, *supra,* section 16.4(b)

[32] See our discussion above about the general branch of the trade and commerce power, particularly heading 1(a)(v) of this letter.

submission of a reference to the Supreme Court of Canada to eliminate any uncertainty concerning the constitutional validity of the Act.

Yours truly,

Ogilvy Renault

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per: L. Yves Fortier, C.C., Q.C

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November 10, 2003

Mr. Michael Phelps
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Dear Mr. Phelps:

Re: Constitutional authority to implement the CSC model

You have asked my opinion on two constitutional questions relating to the Canadian Securities Commission ("CSC") model outlined in Chapter 6 of the Committee's report. The two questions, and a summary of my opinion concerning them, are as follows.

1. *Does the federal government have the legislative authority to enact legislation implementing the CSC model? Do the provinces and territories correspondingly have legislative authority to enact legislation that: (a) incorporates by reference the new federal securities legislation; (b) delegates administrative powers to the CSC; and (c) dissolves their respective existing provincial and territorial securities regulators?*

   The federal government has legislative authority under its general regulation of trade power, conferred by s. 91(2) of the *Constitution Act, 1867*, to implement the CSC model. Based on the factors that the Supreme Court has identified as relevant, the CSC model would constitute a valid general regulation of trade rather than an impermissible regulation of a particular trade. The provinces and territories may enact the corresponding legislation to which this question refers. Legislatures are afforded wide scope to enact incorporations by reference and administrative interdelegations. The power to establish a regulatory body includes the power to dissolve it.

2. *If one or more provinces or territories decide not to enact the legislation described above, and the federal government concludes that this would jeopardize the successful operation of the scheme in other parts of the country, would the federal government nevertheless have the legislative authority to implement the CSC model on a national basis by including in its legislation an express paramountcy clause that plainly demonstrates an intention to enact a complete code and which states that federal legislation alone would govern, to the exclusion of provincial and territorial regulation, on prescribed matters, including amongst other matters: (a) prospectus review; (b) registration of market intermediaries; (c) take-over bid regulation; (d) continuous disclosure by public companies: (e) prospectus exempt financings (f) international securities agreements; and (g) securities regulatory enforcement actions?*

Federal legislation that included an express paramountcy clause of this kind would be effective to exclude the operation of provincial and territorial regulation of the matters to which the paramountcy clause applied. As currently interpreted, the paramountcy doctrine renders provincial legislation inoperative where the application of the provincial legislation would displace the legislative purpose of Parliament. While it is not necessary that it do so, Parliament is entitled to state expressly its purpose that the CSC model, and it alone, should govern specified aspects of securities regulation.

I will now set out the basis for my opinion, dealing with the two questions in turn.

1 *Federal authority to implement, and provincial and territorial authority to defer to, the CSC model*

Federal authority to implement the CSC model

In my view, the federal government has authority under its general regulation of trade power, conferred by s. 91(2) of the *Constitution Act, 1867*, to implement the CSC model. It is also arguable that the federal power to legislate on matters of "national concern", recognized as stemming from the "peace, order and good government" clause in the opening words of s. 91 of the *Constitution Act, 1867*, would support implementation of the model. Other federal powers would be available to support legislation implementing portions of the model. But since the federal government could in my view rely on the general regulation of trade power in implementing the model in its entirety, I will focus my discussion on that power.

The federal general regulation of trade power

Section 91(2) of the *Constitution Act, 1867* gives the federal government a power described as "The Regulation of Trade and Commerce". Since the decision in *Citizens Insurance Co. v. Parsons* (1881), 7 App. Cas. 96, it has been settled constitutional law that the power conferred by s. 91(2) has two branches: (1) the regulation of interprovincial and international trade, and (2) "the general regulation of trade affecting the whole dominion". It has also been settled that s. 91(2) does not authorize regulation of the contracts of a particular business or trade. That power rests with the provinces under s. 92(13) as a matter of property and civil rights.

The general regulation of trade power lay largely unused, and its content largely unexplored, for many years following the *Parsons* case. However, in more recent cases the Supreme Court of Canada has clarified the scope of the power. Where it applies, it authorizes federal regulation not only of interprovincial and international trade, but also of trade within a province.

The leading case on the scope of the power is *General Motors of Canada Ltd. v. City National Leasing Ltd.*, [1989] 1 S.C.R. 641. According to the Court's reasons in that case, five factors are relevant in determining whether federal legislation qualifies as a general regulation of trade. These factors also assist in making this determination in a way that maintains an appropriate balance between federal power under s. 91(2) and the provinces' property and civil rights power under s. 92(13). The five factors are:

(1) the legislation must be part of a general regulatory scheme;

(2) the scheme must be monitored by a regulatory agency;

(3) the legislation must be concerned with trade as a whole rather than with a particular industry;

(4) the legislation should be of a nature that the provinces jointly or severally would be constitutionally incapable of enacting; and

(5) the failure to include one or more provinces or localities in a legislative scheme would jeopardize the successful operation of the scheme in other parts of the country.

The Court stated that these five factors are not exhaustive, and that the presence or absence of any of them will not necessarily be determinative. However, their presence will "make it far more probable that what is being addressed in a federal enactment is genuinely a national economic concern and not just a collection of local ones".

In the *General Motors* case, the Supreme Court applied these factors to uphold the federal *Combines Investigation Act* (now the *Competition Act*) as a general regulation of trade. It had no difficulty finding a regulatory scheme and oversight by a regulatory agency, the Director of Investigation and Research (now the Commissioner of Competition), so that the first two factors were present. It described the last three factors as sharing "a common theme: all three are indications that the scheme of regulation is national in scope and that local regulation would be inadequate". In concluding that the third factor was present, it focused on the generality of application of the *Combines Investigation Act*. It described the Act as "quite clearly concerned with the regulation of trade in general, rather than with the regulation of a particular industry or commodity", and as "aimed at eliminating commercial practices which are contrary to healthy competition across the country, and not in a specific place, in a specific business or industry".

In addressing the last two factors, the Court reviewed what it described as "the diverse economic, geographical, and political factors which make it essential that competition be regulated on the federal level". These included the increased mobility of labour, capital, goods and technology across provincial boundaries, facilitated by improvements in communications

and transportation, and the need for national competition policy to promote and protect the national common market and the welfare of the national economy, free from the distortions that might result from differing provincial competition policies. It saw it as "evident ... that competition cannot be effectively regulated unless it is regulated nationally".

For the same reasons, the Court rejected the argument that the legislation should be read down so as not to apply to intraprovincial trade. Intraprovincial trade could not be excluded both "[b]ecause regulation of competition is so clearly of national interest and because competition cannot be successfully regulated by federal legislation which is restricted to interprovincial trade". It is clear, therefore, that where federal legislation qualifies as a general regulation of trade, it can validly extend not only to interprovincial and international but also to intraprovincial trade.

The CSC model as a general regulation of trade

Based on the factors discussed by the Supreme Court in *General Motors* and the approach to the federal general regulation of trade power that they express, I conclude that federal legislation implementing the CSC model would be constitutionally valid as a general regulation of trade.

The first two factors to which the Supreme Court referred in *General Motors* – that the legislation be part of a general regulatory scheme and that the scheme be monitored by a regulatory agency – would readily be met. The remaining three factors require more detailed discussion.

In my view, legislation implementing the CSC model would properly be described as concerned with trade as a whole rather than with a particular trade or industry, so as to meet the third factor. While it could be argued that the regulation was of a particular trade or industry – the securities trade or industry – that characterization would not accurately capture what the model would entail.

It is true that provincial securities legislation has often been characterized as regulating the securities trade. This characterization fits well with the constitutional basis, s. 92(13) of the *Constitution Act, 1867*, invoked to support provincial legislation: s. 92(13) has long been held to confer on the provinces the power to regulate particular trades or industries. But the CSC model would extend to a great many participants in the capital markets other than dealers, brokers and others who can be regarded as involved in the securities trade or industry *per se*. In extending to issuers, for example, it would apply to market participants engaged in a wide variety of businesses and trades – to all those, whatever their ordinary business or trade, who issue and seek to raise capital in Canada on the strength of securities. In this respect the model can properly be analogized to the generally applicable scheme regulating competition upheld in *General Motors*.

The fourth factor, again, is that the provinces jointly or severally would be constitutionally incapable of enacting the legislation. The Supreme Court did not fully spell out

the meaning of the fourth factor in *General Motors*. It focused more on the fifth factor– whether the failure to include one or more provinces or localities would jeopardize the successful operation of the scheme in other parts of the country – and on the question whether provincial regulation of competition could be effective, than on the question of constitutional incapability. However, its acknowledgement that provinces can and do pass their own competition laws makes it clear that the absence of any provincial power at all in the field is not required for the fourth factor to be present. Although it was not explicit in *General Motors*, the key to the Court's conclusion on the fourth factor seemed to be that the increasingly interprovincial nature of the flow of goods, services and capital precluded the provinces from effectively setting competition policy and regulating competition.

A variety of means have been suggested through which the provinces can enhance the cooperation that already exists between them in securities regulation and deploy their powers to create a virtual scheme of national regulation. But this does not necessarily mean that the constitutional incapability factor is absent. The Supreme Court's recent decision in *Unifund Assurance Co. v. Insurance Corp. of British Columbia*, 2003 SCC 40, emphasizes that a province may only exercise its regulatory authority over people and matters with a sufficient connection to the province. The Committee's research, as I understand it, strongly suggests that capital markets have become increasingly integrated, and that Canada's capital markets have become national in scope. It can readily be argued that separate provincial regulatory regimes, each subject to territorial limits, are constitutionally incapable of comprehensively regulating securities, just as they could not effectively regulate competition.

The fifth factor – the potential impact of failure to include one or more provinces or localities on other parts of the country – encompasses in the securities context, in my view, the potential consequences of regulatory failure in one province for capital markets and participants in capital markets elsewhere in Canada. There appears to be a sound basis for concluding that this factor is present. For example, one province's failure to adopt an adequate regulatory scheme could both impair the reputation of Canadian capital markets generally, and adversely affect the residents of other provinces whose securities are traded there.

According to the decision in *General Motors*, the presence of all of the factors is not strictly necessary for legislation to constitute a general regulation of trade. The underlying purpose of all of the factors is to help determine whether what the scheme is addressing is genuinely a national economic concern and not just a collection of local ones. The last three factors go to whether the scheme of regulation is national in scope and whether local regulation would be inadequate.

Upholding the CSC model as a general regulation of trade could therefore ultimately turn on how the courts approached the two overarching questions of national scope and adequacy or effectiveness of provincial regulation. The answer to the national scope question would likely favour upholding the model. The Supreme Court has shown itself prepared, in cases like *Multiple Access Ltd. v. McCutcheon*, [1982] 2 S.C.R. 161, and *Global Securities Corp. v. British Columbia (Securities Commission)*, [2000] 1 S.C.R. 494, to recognize that there is a strong transprovincial and transnational dimension to Canadian capital markets.

The Committee's conclusions appear to provide further support for this assessment. The CSC model would be general and national, not particular and local, in its application.

The Court's repeated references in *General Motors* to the need for federal regulation if there is to be effective regulation indicate that the question of effective regulation might well be determinative. The way in which the general regulation of trade power has developed thus places the Court in a somewhat unusual position. Ordinarily, as the Supreme Court stated in *Reference re Firearms Act (Can.)*, [2000] 1 S.C.R. 783, the Court does not evaluate the efficacy – or lack of efficacy – of legislation in deciding constitutional division of powers questions. Ordinarily, for a number of institutional reasons, it is not for judges but for legislators to gauge the effectiveness of legislation.

In the *General Motors* case, the Supreme Court paid heed in considering the effectiveness question to the conclusions of studies that formed part of the background to the enactment of federal competition legislation. It was appropriate in my view for the Court to do so. It would be equally appropriate in considering the effectiveness question in relation to federal legislation implementing the CSC model for courts to take account of your Committee's conclusions and recommendations, along with other views considered by Parliament before enacting the legislation. There will almost certainly continue to be a range of opinions on the effectiveness question, as there has been to date. But particularly if the material put before it gave Parliament a reasonable basis to conclude that federal securities regulation is necessary to ensure effective regulation, it is likely in my view that legislation implementing the CSC model would be held constitutionally valid as a general regulation of trade.

Provincial and territorial authority to defer to the CSC model

Once the federal legislation implementing the CSC model was enacted, in my view the provinces would be fully entitled to enact legislation incorporating the new federal securities legislation by reference, delegating administrative powers to the CSC and dissolving their respective securities regulators.

Because the territorial legislatures do not have independent constitutional status, and the exercise of their legislative authority is subject to federal legislation, the federal government would have authority to decide how best to deal with securities regulation in the territories following the implementation of the CSC model. I will therefore confine the balance of this discussion to the provinces' authority to defer to the CSC model.

The enactment of the federal legislation would not by itself preclude the provinces from continuing to regulate securities. They could continue to do so. The federal power to enact legislation that constitutes a general regulation of trade does not take away the provinces' regulatory powers. Whether their legislation would continue to operate if they chose not to defer to the new federal legislation would depend on the application of the paramountcy doctrine, discussed below in answer to the Committee's second question.

But there would be no constitutional difficulty with their exercising their powers, if they chose to do so, by referentially incorporating the federal legislation and delegating administrative powers to the CSC. It is constitutionally impermissible for the federal Parliament and provincial legislatures to delegate legislative authority directly to each other. But as the Supreme Court of Canada confirmed in *R. v. Furtney*, [1991] 3 S.C.R. 89, "Parliament may delegate legislative authority to bodies other than provincial legislatures, it may incorporate provincial legislation by reference and it may limit the reach of its legislation by a condition, namely the existence of provincial legislation." Provincial legislatures have corresponding authority to delegate to other bodies, to incorporate federal legislation by reference and to limit the reach of provincial legislation by conditioning its application on federal legislation.

Incorporation by reference entails enacting legislation providing that a matter within the legislature's authority be governed by legislation enacted by another legislature, either as it exists at the time of the incorporation or, where the incorporating legislation is explicit on this point, as it might be modified in the future. This is regarded as one legislature's adopting as its own and for its own purposes legislation enacted by another. It is very common in Canada to combine this technique with the delegation of regulatory authority to a regulatory body created by another legislature, coupled with a direction to that regulatory body to apply that legislature's law.

While there are suggestions in the case law that the power of delegation is subject to "reasonable limits", and that Parliament or a legislature may not go so far as to "abdicate" or "abandon" its powers to a delegate, very broad delegations of authority have repeatedly been upheld. These include delegations that give regulatory bodies extensive powers to fashion regulatory schemes governing particular areas of economic activity. The courts have appreciated the desirability of intergovernmental cooperation in enacting comprehensive schemes of regulation. In my view it is very unlikely that any delegation of authority to regulate securities would be regarded as an impermissible abdication or abandonment of legislative power.

There would also, in my view, be no constitutional difficulty with dissolving existing regulators. As a matter of legislative sovereignty, the power to enact legislation includes the power to repeal it. Legislation that created a regulatory body could be amended or repealed to dissolve it.

2. Federal authority to exclude provincial and territorial regulation through paramountcy

In my view the federal government would be entitled to ensure that the CSC model operated as a complete code governing specified securities matters by including in the implementing legislation an express paramountcy clause. Federal legislation would be effective to exclude provincial securities regulation under the paramountcy doctrine if it plainly demonstrated an intention that it and it alone govern the matters from which provincial regulation was to be excluded. An express paramountcy clause would constitute an unmistakable, and in my view constitutionally effective, expression of this intention.

Because of the territories' dependant constitutional status, there would be no need to invoke the paramountcy doctrine to exclude the operation of territorial securities regulation. The federal Parliament could directly override territorial legislation.

The paramountcy doctrine applies where there is conflict in operation between valid provincial and valid federal legislation. Its result is that the federal legislation prevails, and the provincial legislation is inoperative, to the extent of the conflict.

The key determinant of whether the paramountcy doctrine applies is the test for identifying a conflict in operation between the federal and the provincial legislation. As the Supreme Court's recent decisions make clear, the test now applied is whether operation of the provincial legislation "would displace the legislative purpose of Parliament".

That phrase first appeared in *Multiple Access Ltd. v. McCutcheon*, where the Supreme Court appeared to adopt a stringent test of express contradiction for determining the existence of a conflict sufficient to trigger operation of the paramountcy doctrine. Paramountcy was invoked in that case to argue that federal insider trading legislation, applicable to federally incorporated companies, rendered inoperative the virtually identical insider trading provisions of the Ontario *Securities Act*.

The Supreme Court held that the paramountcy doctrine did not apply. It stated the test as one of "actual conflict in operation as where one enactment says 'yes' and the other says 'no'; 'the same citizens are being told to do inconsistent things'; compliance with one is defiance of the other". Duplicate legislation did not present a conflict based on this test. Rather, duplication was "the ultimate in harmony". The Court added that because the two sets of legislation were so similar, "the legislative purpose of Parliament will be fulfilled regardless of which statute is invoked by a remedy-seeker; application of the provincial law does not displace the legislative purpose of Parliament." The Court's inference was that Parliament did not intend that only its legislation govern.

Three more recent Supreme Court decisions signal a less restrictive approach to identifying a conflict, one that builds on the reference in *Multiple Access* to "displacing the legislative purpose of Parliament", and gives primacy to Parliament's intention as to whether its legislation should operate as a complete code.

In *Bank of Montreal v. Hall*, [1990] 1 S.C.R. 121, the Court held that provincial legislation setting conditions on secured creditors' enforcement of security interests conflicted with and was rendered inoperative by federal legislation governing *Bank Act* security. The federal statute gave a bank holding the security an immediate right to realize on it on default. The Court rejected the argument that there was no conflict in operation because banks could simply follow the provincial legislation. "The focus of the inquiry," it stated, "must be on the broader question whether operation of the provincial Act is compatible with the federal legislative purpose." "Dual compliance will be impossible when application of the provincial statute can fairly be said to frustrate Parliament's legislative purpose." The Court summarized

the situation as one in which Parliament had "enacted a complete code", so that there was "no room left for the operation of the provincial legislation".

In *M & D Farm Ltd. v. Manitoba Agricultural Credit Corp.*, [1999] 2 S.C.R. 961, the Court referred to the "extended meaning" given by the relevant jurisprudence to the "express contradiction" between federal and provincial statutes necessary to trigger the paramountcy doctrine. In that case a farmer had obtained a stay of proceedings by creditors under federal legislation. As permitted by provincial legislation, a mortgagee then obtained leave from the court to commence foreclosure proceedings. Though the creditor could comply with both statutes by not taking enforcement measures, the Court found an operational conflict: the legal system could not simultaneously create an entitlement to enforce and a prohibition on enforcement. The Court was also prepared to look to the substance rather than the form of the two enactments – one of which directly stayed creditor enforcement actions and the other of which required leave to commence enforcement proceedings – to recast them as creating conflicting directives to the court dealing with enforcement of the mortgage.

In *Law Society of British Columbia v. Mangat*, [2001] 3 S.C.R. 113, the Court again emphasized the importance of looking, in determining whether a conflict in operation exists, at "whether the application of the provincial law will displace the legislative purpose of Parliament". The Court found an operational conflict where a provincial law prohibited non-lawyers from acting in immigration proceedings, while the federal law authorized non-lawyers to appear and charge a fee.

The Court dismissed as "superficial" the suggestion that there was no operational conflict because a person could comply with both enactments, either by becoming a lawyer or by not charging a fee. While complying with the stricter provincial statute would necessarily involve complying with the federal statute, dual compliance was impossible based on the "expanded interpretation" of conflict in *M & D Farm* and *Bank of Montreal v. Hall*. "Where there is an enabling federal law," the Court stated, "the provincial law cannot be contrary to Parliament's purpose."

In my view, the current focus in the paramountcy cases on the purpose of Parliament means that the federal government could, through legislation implementing the CSC model, preclude the operation of provincial securities regulation. It would not be strictly necessary in my view to include an express paramountcy clause to bring about this result. It would be sufficient that the legislation plainly manifested an intention that it and it alone govern the specified aspects of the transactions and activities to which it applied. If this intention was apparent, then a court should conclude, whatever the degree of similarity or duplication between the federal and the provincial legislation, that the operation of the provincial legislation would "displace the legislative purpose of Parliament", so that the paramountcy doctrine would render it inoperative.

While an express paramountcy clause would not be necessary if this intention was otherwise clearly expressed, it would in my view be open to Parliament to include an express paramountcy clause specifying that the federal legislation alone should govern. An express

paramountcy clause would, among other things, make it clear that Parliament's intention was not the same as that expressed in the legislation considered in the *Multiple Access* case. The question of paramountcy of the CSC model would arise in a very different legislative and policy context from that of the *Multiple Access* case. But because that case was a securities case, in which the Supreme Court applied the paramountcy doctrine so as to permit federal and provincial regulatory schemes to operate concurrently, a court might in the absence of an express paramountcy clause be tempted to follow *Multiple Access* and hold that both sets of regulations could operate. An express paramountcy clause would constitute an unmistakable expression that the continued operation of provincial regulation in the face of the CSC model would "displace the legislative intention of Parliament".

Including express paramountcy clauses has not been the ordinary practice in federal legislative drafting. As a result, courts have typically been left to infer Parliament's legislative purpose from the operative terms of the legislation. But I see no reason in principle why Parliament should not be entitled to make its purpose express, and why the courts should not give effect to an express paramountcy clause in federal securities legislation.

As I understand it, the Committee's second question contemplates an express paramountcy clause that would not apply generally to the legislation implementing the CSC model, and would thus not seek to exclude all aspects of provincial securities regulation. Instead, it would cover specified aspects of securities regulation, from which Parliament considered it necessary to exclude provincial regulation to avoid jeopardizing the operation of the federal scheme.

Framing an express paramountcy clause in this way would in my view enhance the likelihood that the courts would accept this technique. An approach along these lines should not as a legal matter be required for an express paramountcy clause to be given effect. However, a more focused rather than a more general clause might as a practical matter be regarded as more palatable, because it would allay possible concerns about the extent of the impact of paramountcy on a recognized field of provincial regulation.

Yours very truly,

John B. Laskin

JBL/tp

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November 10, 2003
File No.: WIS00030

WPC – Committee to Review the Structure of
Securities Regulation in Canada
25th Floor
700 West Georgia Street
Vancouver, B.C. V7Y 1B3

Attention: Michael Phelps, Chair

Dear Sirs/Mesdames:

Re: Constitutional Opinion on Securities Regulation

You have asked for my opinion on two questions relating to the proposal for the creation of a Canadian Securities Commission ("CSC"):

1. Does the federal government have the legislative authority to enact legislation implementing the CSC model? Do the provinces and territories correspondingly have legislative authority to enact legislation that: (a) incorporates by reference the new federal securities legislation; (b) delegates administrative powers to the CSC; and (c) dissolves their respective existing provincial and territorial securities regulators?

2. If one or more provinces or territories decides not to enact the legislation described above, and the federal government concludes that this would jeopardize the successful operation of the scheme in other parts of the country, would the federal government nevertheless have the legislative authority to implement the CSC model on a national basis by including in its legislation an express paramountcy clause that plainly demonstrates an intention to enact a complete code and which states that federal legislation alone would govern, to the exclusion of provincial and territorial regulation, on prescribed matters, including amongst other matters: (a) prospectus review; (b) registration of market intermediaries; (c) take-over bid regulation; (d) continuous disclosure by public companies; (e) prospectus exempt financings; (f) international securities agreements; and (g) securities regulatory enforcement actions?

Introduction

I have been asked to consider a proposed model for securities regulation in which a single regulator (the CSC) would administer a single law providing a securities regulatory structure for Canada. The relevant features of the model include:

(a) The new structure would involve a collaborative approach on the part of the federal and provincial governments.

(b) Parliament would enact a new Canadian Securities Act providing a comprehensive scheme of capital markets regulation for the whole country. The new statute would be based on the Uniform Securities Law which has been under development.

(c) The new statute would be administered by a single commission, the CSC.

(d) The mandate of the CSC would reflect the objectives of securities regulation.

(e) A Securities Policy Ministerial Committee would be established, consisting of the responsible federal and provincial ministers.

(f) A Nominating Committee would be established to provide for provincial and industry input into the choice of Commissioners for the CSC.

(g) The new statute would incorporate a mechanism under which amendments to the statute would require a defined level of provincial approval.

I have not seen any drafts of any proposed federal legislation or any drafts of the Uniform Securities Law. My opinions regarding the proposed model are therefore necessarily general in nature.

In the course of preparation of this opinion, I was provided with a number of interesting background papers dealing with the nature of capital markets. However, I have not been asked to assume any particular facts. For the purpose of this opinion, I have not attempted to resolve any of the points which might be the subject of contested evidence.

1. Does the federal government have the legislative authority to enact legislation implementing the CSC model? Do the provinces and territories correspondingly have legislative authority to enact legislation that: (a) incorporates by reference the new federal securities legislation; (b) delegates administrative powers to the CSC; and (c) dissolves their respective existing provincial and territorial securities regulators?

In summary, it is my opinion that Parliament has the legislative authority to enact legislation implementing the CSC model. Further, the provinces and territories have legislative authority to enact legislation that incorporates federal securities legislation by reference, delegates administrative powers to the CSC and dissolves the existing provincial and territorial securities regulatory bodies.

In particular, in my view:

(a) the provincial jurisdiction over securities regulation has been consistently upheld by the courts;

(b) the territories exercise a delegated jurisdiction from Parliament;

(c) Parliament also has legislative jurisdiction over securities legislation under the trade and commerce power, which would give Parliament the authority to implement the CSC model;

(d) the interdelegation of powers contemplated in this model would be upheld by the courts.

I will discuss these points in turn.

In the discussion which follows, it is important to appreciate that "securities regulation" is a complex matter with multiple aspects. The raising of capital for business ventures involves (among other things) the share structure of corporations; a range of types of securities – equity, debt, derivatives and interests in real estate; the private distribution of securities; primary distribution to the public and the secondary market in such securities; intraprovincial, interprovincial and international trade in securities; the regulation of market conduct; the regulation of substantive matters, such as takeovers, insider trading, compensation to promoters and governance issues; the regulation of those offering to sell securities; prospectus and other disclosure requirements; a general concern for the protection of investors; and a general concern for the efficiency and integrity of the capital markets.

(a) Provincial Jurisdiction

The courts have consistently upheld the provincial jurisdiction over securities regulation. I would agree with Hogg's comment that the provincial jurisdiction has been given a "broad scope" by the courts. The constitutional basis has almost always been given as section 92(13) of the *Constitution Act, 1867*, "Property and Civil Rights in the Province". The line of cases which have established this are well known and often cited, and it is not necessary to set out the chronology here.

The extent of the provincial power to regulate interprovincial and international securities transactions, however, does require analysis of the reasoning given in those court decisions.

If the securities regulation cases were based solely on a marketing analysis, then one might think that a case such as *Attorney-General of Manitoba v. Manitoba Egg and Poultry Association*, [1971] S.C.R. 689, would apply, which found that the province lacked the jurisdiction to regulate all egg sales in Manitoba since, by regulating inter-provincial sales as part of these, the legislation invaded Parliament's authority over trade and commerce. Although there are some references in the decisions to intraprovincial trading in securities, the courts have generally not applied the analogy of the marketing cases to securities regulation.

From the cases, I have identified four lines of reasoning which have been applied to the characterization of legislation in this area:

(a) the earliest and many subsequent court decisions emphasized provincial jurisdiction over the protection of investors;

(b) a number of the cases involved the power of the provinces to regulate the people who promote or sell securities within the province;

(c) the cases on federal companies emphasized that certain matters which bear on securities regulation (the share structure of companies, takeover legislation, insider trading) should be seen as part of the jurisdiction over the incorporation of the company. Although no cases have had to rely on this point, this principle could also provide a basis for regulating similar areas for provincially incorporated companies.

(d) the ancillary doctrine allows provinces to regulate matters which are incidental to otherwise valid provincial jurisdiction.

All of these provide a basis on which provinces can, directly or indirectly, deal with transactions which are interprovincial or international in nature. I will deal with them in turn.

(i) Investor Protection

From the earliest cases, the courts have avoided characterizing securities regulation as similar to marketing legislation. Securities regulation has been seen as closer in character to insurance regulation. The courts have seen the legislation as directed to public protection, rather than to issues of supply and pricing.

In *Attorney General of Manitoba v. Attorney General of Canada*, [1929] A.C. 260, Viscount Sumner found that the provincial securities legislation could not prevent a federally incorporated company from selling its own shares. He said:

> Their Lordships were informed, and the Acts clearly bear it out, that among the objects with which this legislation was framed was the protection of inexperienced residents in the Province from the temptation to participate in enterprises ill-designed, ill-equipped, and ill-conducted, and from subsequent losses of their savings and disappointment of their hopes. The subject was one well worthy of the attention and care of statesmen and, it may be, was peculiarly within the domain of provincial regulation; the method adopted was that of prevention, instead of or in addition to such cure as criminal prosecution and punishment can afford.

The same approach was taken in the subsequent decision of the Privy Council in *Lymburn v. Mayland*, [1932] A.C. 318, in upholding the Alberta *Security Frauds Prevention Act*:

> There is no reason to doubt that the main object sought to be secured in this part of the Act is to secure that persons who carry on the business of dealing in securities shall be honest and of good repute, and in this way to protect the public from being defrauded.

These words were relied on by the Supreme Court of Canada in *Smith v. The Queen*, [1960] S.C.R. 776. In his concurring judgment, Cartwright J. saw the legislative provisions as being "an integral part of a law providing for the regulation of the sale of securities in the province with a view to protecting the public from being defrauded".

The explicit adoption of the "public protection" basis coupled with a rejection of the "marketing" approach came in the judgment of Fauteux J. in *Gregory & Co. v. Quebec (Securities Commission)*, [1961] S.C.R. 584:

> Nor is this conclusion affected by the decisions rendered in a group of cases referred to by counsel for appellant, where the incidence of export trade of farm products on the validity of certain provincial marketing acts was considered. … These decisions are also irrelevant. The *Act Respecting Securities*, 3-4 Elizabeth II, c. 11, is not marketing legislation within the meaning attending the legislation considered in these cases. In order to protect the public against fraud, it provides for the establishment and operation of a control and supervision over the conduct, in the Province of Quebec, of persons engaged, therein, in carrying on the business of trading in securities or acting as investment counsel.

The characterization of provincial securities legislation was put more broadly in *Duplain v. Cameron*, [1961] S.C.R. 693, where Chief Justice Kerwin and Ritchie J. both characterized the legislation as having as its main object "the regulation of trading in securities within that province".

I will only mention one further case. In *Asbestos Minority Shareholders v. Ontario (Securities Commission)*, [2001] 2 S.C.R. 132, 2001 SCC 37 the court referred approvingly to two of the objects of the Ontario legislation which may be paraphrased as protection of the public and protection of the integrity of capital markets.

Because the courts have consistently characterized provincial securities legislation in this way, they have always upheld the provincial power to regulate the offering or sale of securities within the province. The result is that there is a basis for jurisdiction which does not depend on whether the sale will be interprovincial or not.

(ii) Regulation of Sellers

Securities legislation generally has two aspects: regulation of trading and securities, and regulation of the persons who sell or offer for sale securities in the province. The provincial jurisdiction over such dealers in securities follows from the general approach taken by the courts to the characterization of provincial securities laws, which I have described above. A number of the constitutional cases involve jurisdiction over such dealers. I do not need to list them all. What is notable is that the courts have in the past given, and continue today to give, this jurisdiction over such persons a considerable extraprovincial effect.

One example is *Gregory & Co.* In that case, a Quebec broker only sold securities to persons outside Quebec. Nonetheless, the court held that the broker was subject to the jurisdiction and control of the Quebec Securities Commission. It did not matter that the broker's customers were outside the Province. It carried on the business of trading in securities within Quebec. Its offices were in Quebec; it contacted its customers from

Quebec; payments were made to it at its offices in Quebec; and the companies whose shares the broker actively promoted were all Quebec companies and their shares were transferable only in Quebec. The Court rejected the argument that the broker's activities were entirely interprovincial or international. (It is true that the Court did not have a formal challenge to the constitutionality of the Quebec legislation before it, but the decision is cast in constitutional terms.)

The Manitoba Court of Appeal upheld the reverse situation in *R. v. W. McKenzie Securities Ltd.* (1966) 56 D.L.R. (2d) 56. In that case, the broker was located in Ontario and solicited customers within Manitoba. The court did not consider that the provincial statute was intended to catch "interprovincial trading". However, it referred to the "public protection" characterization of provincial securities laws and found that the Ontario broker was in fact engaged in trading in securities in Manitoba, as the solicitations took place in Manitoba.

The result in *McKenzie Securities* has sometimes been questioned. However, for present purposes I see this case as another example where provincial legislation which in fact has the result of regulating interprovincial trading was upheld because it was not characterized as marketing legislation, but instead characterized as regulating the trading of securities in the province for the protection of the public.

Finally, the jurisdiction of a provincial regulator over a market participant outside the province was affirmed by the Supreme Court of Canada in the *Asbestos Minority Shareholders* case. The Ontario Securities Commission had a public interest jurisdiction over the government of Quebec, even in relation to a transaction which was wholly a Quebec transaction, as Quebec had taken the benefit of an exemption under the Ontario legislation. As I read the decision, the Court did not find that the OSC had direct jurisdiction over the transaction in question, but it did have the jurisdiction to consider making an order against Quebec under its public interest power. The result, however, is that the OSC could properly found its regulatory action on an extraprovincial transaction.

In summary, so long as the court is willing to characterize the legislation as aimed at a matter within provincial jurisdiction, the regulator can in fact regulate interprovincial and international trading. If the provincial legislation is characterized as aimed at such trading, then the logical result would be that the province would not have jurisdiction, but the courts have carefully and consistently avoided any such characterization of provincial securities laws.

(iii) Company Law Jurisdiction

The question of company law jurisdiction has only arisen in the constitutional cases on securities regulation where Dominion companies have sought to say that they are not

subject to provincial securities legislation. So far as my research has gone, the provinces have not had to rely on their company law jurisdiction to uphold their securities legislation. However, I think that in theory this would provide a basis for jurisdiction in respect of provincially incorporated companies, at least in respect of such matters which have been characterized in the federal company cases as matters of company law rather than matters of security law (share structure and issuance, insider trading, takeover bid regulation). On principle, it should also apply to the regulation of corporate governance.

(iv) Incidental Effect

If the pith and substance of a provincial statute is a subject matter within provincial jurisdiction, then there are a number of cases which hold, perhaps illogically, that the provincial legislation can have an incidental effect even on matters which are within exclusive federal jurisdiction: *Irwin Toy Ltd. v. Quebec (Attorney General)*, [1981] 1 S.C.R. 927; see the discussion by Laskin J.A. in *Greater Toronto Airports Authority v. Mississauga* (2000), 50 O.R. (3d) 641 at paras. 40 to 45.

In addition, the "ancillary doctrine" permits provincial legislation to include provisions which are necessarily incidental to the legislative scheme.

The Supreme Court of Canada referred to the ancillary doctrine and the question of incidental effects in the *Global Securities Corporation v. British Columbia (Securities Commission)*, [2000] 1 S.C.R. 494, 2000 SCC 21 decision. For the purpose of the decision, Iacobucci J. found that the extraprovincial effects were incidental to the dominant purpose of the legislation.

In general terms, I see *Global Securities* and *Asbestos Minority Shareholders*, the two recent Supreme Court of Canada decisions on provincial securities laws, as consistent with the line of authority characterizing provincial securities laws. Indeed, in *Global Securities* Iacobucci J. quotes from both *Smith* and *Lymburn*. Both of these recent cases stress the provincial jurisdiction over persons who are part of the securities market within the province. In order to effectively regulate the conduct of such persons, the securities commissions can have regard to extraprovincial events. I would not see these decisions as extending provincial jurisdiction in any significant way. However, it is equally clear that the court was not prepared to revisit the basis for provincial jurisdiction, even though it expressly recognized in *Global Securities* the international character of a securities market and the impact of the Internet (see para. 28). Neither case suggests that the court is interested in applying a marketing analysis to the provincial legislation and so stringently restrict provincial jurisdiction to intraprovincial transactions.

The suggestion has been made that the courts would have been more willing to strike down provincial securities laws if there had been federal securities law in place. This has

to be a matter of speculation and it is difficult to offer any opinion. However, there is no indication in the cases themselves that the characterization of the provincial legislation, which is now firmly established, was adopted for this reason. If Parliament were now to pass securities legislation, I do not expect, at this stage, that this would affect the characterization of the provincial laws.

(b) Jurisdiction of the Territories

The territories simply exercise the jurisdiction delegated to them by Parliament, so there is no constitutional impediment to Parliament dealing with the matter of securities regulation within the territories.

(c) Jurisdiction of Parliament

In respect of Parliament's jurisdiction to pass securities legislation on the CSC model, in my opinion:

(a) there is a strong argument that this could be supported under the trade and commerce power;

(b) I am doubtful that such legislation could be supported as legislation in relation to peace, order and good government; and

(c) I do not think that comprehensive federal legislation could be based on any other grounds (for example, section 92(10) or the banking power).

(i) Trade and Commerce Power

It is familiar ground to say that *Citizens Insurance Company of Canada v. Parsons* (1881), 7 App. Cas. 96, established that section 91(2), "The Regulation of Trade and Commerce", did not confer jurisdiction on Parliament in relation to all trade and commerce, as this would constitute too great an invasion of the provincial jurisdiction over property and civil rights. Reading the two heads of power together, the Privy Council concluded that Parliament's jurisdiction was restricted to two situations: international and interprovincial trade, and general regulation of trade affecting the whole country.

In my view, federal securities regulation could be supported on either of these branches of the trade and commerce power.

There seems little doubt that the first branch, interprovincial and international trade, could be used as a basis for federal securities legislation. The difficulty would be defining the transactions which were excluded from that legislation on the basis that they

were intraprovincial trades. I do not need to attempt to resolve this question for the purpose of this opinion, however. I can safely assume that the situation under such legislation would be that the federal legislation applied to the majority of securities trading, but that there would be a substantial quantity of interprovincial trades which fell outside the scope of the legislation.

The second branch of the trade and commerce power, a general regulation of trade affecting the whole country, was given new life when applied by the Supreme Court of Canada in *General Motors of Canada Ltd. v. City National Leasing*, [1989] 1 S.C.R. 641, as the basis for the expanded federal competition legislation.

Chief Justice Dickson saw the issue as being the proper balancing of the federal trade and commerce power and the provincial jurisdiction over property and civil rights. He said at page 660:

> The true balance between property and civil rights and the regulation of trade and commerce must lie somewhere between an all pervasive interpretation of s. 91(2) and an interpretation that renders the general trade and commerce power to all intents vapid and meaningless.

The approach laid out by Dickson C.J.C. was to determine, on a case by case analysis, whether the federal enactment addressed a genuine national economic concern or just a collection of local ones (page 663). To assist in this analysis, he set out 5 indicia, although he emphasized that this only amounted to a "preliminary check-list", and they did not represent an exhaustive list of traits and the presence or absence of any of the indicia was not necessarily determinative.

The 5 indicia are:

1. The impugned legislation must be part of a general regulatory scheme;
2. The scheme must be monitored by the continuing oversight of a regulatory agency;
3. The legislation must be concerned with trade as a whole rather than with a particular industry;
4. The legislation should be of a nature that the provinces jointly or severally would be constitutionally incapable of enacting; and
5. The failure to include one or more provinces or localities in a legislative scheme would jeopardize the successful operation of the scheme in other parts of the country.

The process for determining constitutionality contemplated by Dickson C.J.C. involved, as well, an assessment of the seriousness of the encroachment on provincial powers. Once the court, applying the 5 indicia, has determined that the federal scheme is valid, then it has to consider whether any challenged provision is sufficiently integrated into the legislative scheme that it can be upheld, and in making this determination the court must consider the degree of encroachment on provincial powers.

Although the flexible approach set out by Dickson C.J.C.. does not lend itself to certainty, in my opinion federal securities legislation is the kind of scheme which should fit within the second branch of the trade and commerce power.

The first two indicia relate to the regulatory structure of the federal legislation. I assume that any federal legislation would be drafted to satisfy these two points.

The third factor is that the legislation must be concerned with trade in general, rather than a particular industry. Although from one point of view securities trading could be viewed as a particular industry, I regard the operation of the capital markets as having a unique role in our economy which qualifies as a "genuine national economic concern", to use Dickson C.J.C.'s words. The raising of capital for business ventures is foundational for all economic activity in the country. In this sense, it is part of the infrastructure of the economy, rather than a particular industry. The capital markets have a unique economic character, and the case by case analysis should recognize this.

This approach is consistent with the comment of La Forest J. in *Black v. Law Society of Alberta*, [1989] 1 S.C.R. 591 at p. 609, that a dominant purpose of the *Constitution Act, 1867* was not merely to establish national unity but also to create a national economy.

I think the fourth factor is also satisfied. I think it is clear that there are aspects of the securities market which the provinces cannot address. Their legislation cannot be directed at interprovincial or international trade, and although the provincial legislation can have an incidental effect in this area, this is far from complete coverage.

The fifth factor asks whether the failure to include one or more provinces in the scheme would jeopardize the successful operation of the regulatory scheme in other parts of the country. This is, like the other indicia, intended as a test of whether the legislation is in fact addressing a national concern or a collection of local concerns. In my view, it is quite possible that the actions of one province, if allowed to opt out, could jeopardize the successful operation of the scheme throughout the rest of the country. (It is conceivable that an arrangement could be concluded between the federal government and a dissenting province which had the effect of preserving a properly national scheme. If the end result is a national scheme, then such an arrangement would not disqualify the federal legislation from support on the second branch of the trade and commerce power.)

In summary, in my view Parliament could pass legislation under the trade and commerce power enacting the CSC model.

(ii) Peace, Order and Good Government

The residual power in the opening words of section 91 to make laws for the peace, order and good government of Canada are the basis on which dominion companies legislation is founded. It has been suggested (see Leckey and Ward, "Taking Stock: Securities Markets and Division of Powers", (1999) 22 Dalhousie L.J. 250) that this power could also be used to support federal securities legislation. This is not an unreasonable argument. However, I do not view it is as strong an argument as that for reliance on the trade and commerce power.

The relevant aspect of peace, order and good government is not its application to emergencies but what has been called the "national concern" branch.

In *Attorney General for Ontario v. Canada Temperance Federation*, [1986] A.C. 193, Viscount Simon said:

> In their Lordships' opinion, the true test must be found in the real subject matter of the legislation: if it is such that it goes beyond local or provincial concern or interests and must from its inherent nature be the concern of the Dominion as a whole (as, for example, in the *Aeronautics* case and the *Radio* case), then it will fall within the competence of the Dominion Parliament as a matter affecting the peace, order and good government of Canada, although it may in another aspect touch on matters specially reserved to the provincial legislatures. War and pestilence, no doubt, are instances; so, too, may be the drink or drug traffic, or the carrying of arms.

The national concern branch has been used to uphold federal jurisdiction over aeronautics, the national capital region, marine pollution and (in part) nuclear energy.

In *R. v. Crown Zellerbach Canada Ltd.*, [1988] 1 S.C.R. 401, Le Dain J. discussed and applied the national concern branch. He summarized the applicable principles as follows, at pp. 431 to 432:

> 1. The national concern doctrine is separate and distinct from the national emergency doctrine of the peace, order and good government power, which is chiefly distinguishable by the fact that it provides a constitutional basis for what is necessarily legislation of a temporary nature;

2. The national concern doctrine applies to both new matters which did not exist at Confederation and to matters which, although originally matters of a local or private nature in a province, have since, in the absence of national emergency, become matters of national concern;

3. For a matter to qualify as a matter of national concern in either sense it must have a singleness, distinctiveness and indivisibility that clearly distinguishes it from matters of provincial concern and a scale of impact on provincial jurisdiction that is reconcilable with the fundamental distribution of legislative power under the Constitution;

4. In determining whether a matter has attained the required degree of singleness, distinctiveness and indivisibility that clearly distinguishes it from matters of provincial concern it is relevant to consider what would be the effect on extra-provincial interests of a provincial failure to deal effectively with the control or regulation of the intra-provincial aspects of the matter.

The last item, which Le Dain J. called the "provincial inability" test, is essentially the same as the fourth of Dickson C.J.C.'s indicia in *General Motors*. I have already indicated that I think this test could be satisfied.

In respect of the second item, it may be difficult to argue that securities regulation or capital markets are new matters. However, there is a plausible argument that they have become matters of national concern.

The test which I see as problematic is the requirement that the matter have a "singleness, distinctiveness and indivisibility that clearly distinguishes it from matters of provincial concern". The operation of capital markets is complex and multi-faceted. There is no clear separation between public trading and private distributions of securities, or between public trading and the company law issue of share structure and issuance, insider trading and takeover bids. I am inclined to think that any federal legislation could properly be characterized as a somewhat artificial segregation of what is a larger matter.

My view on this is supported by the express finding by the Supreme Court of Canada in two decisions (*Smith*, supra, and *Multiple Access*, infra) that securities regulation is a "double aspect" area. If there are aspects of security regulation which are properly provincial, then it is difficult to see how this could be characterized as a single, distinctive and indivisible matter.

Further, if the federal legislation can be upheld under the trade and commerce power, then I think on principle the courts would uphold it on this ground and not go on to consider peace, order and good government.

(iii) Other Heads of Power

Some aspects of federal securities legislation could be upheld on the basis of the criminal law (as with the false prospectus offence) or as aspects of the law relating to the incorporation of dominion companies. However, neither of these would provide support for comprehensive federal securities regulation.

It has also been suggested that federal legislation could be supported on the basis of section 92(10)(a), section 92(10)(c) or section 91(15) (the banking power). In my view, none of these is likely to provide a sound basis for federal jurisdiction.

Section 92(10)(a) gives Parliament exclusive jurisdiction over federal works and undertakings. The wording of the subsection is:

> Lines of Steam or other Ships, Railways, Canals, Telegraphs, and other Works and Undertakings connecting the Province with any other or others of the Provinces, or extending beyond the Limits of the Province.

Section 92(10)(a) has only been applied to transportation or communications works or undertakings. It provides the basis for federal jurisdiction over telecommunications companies and broadcasting companies. It is hard to see how the securities industry could be shoehorned into this provision. The fact that the modern securities industry, and the modern markets, use telecommunications links for trading purposes cannot provide the basis. If this were the case, most modern industries would fall within the category. The category is intended to be restricted to those operations which actually serve, as their primary purpose, to connect provinces. The various players in the securities industry do not have the provision of communications facilities as their purpose. Instead, they use the facilities supplied by communications companies in order to carry on their own activity.

Section 92(10)(c) allows for federal jurisdiction over "works" which are "declared by the Parliament of Canada to be for the general advantage of Canada or for the advantage of two or more of the provinces." I do not see how the securities industry could legitimately be characterized as a "work", a term which suggests an identifiable physical presence.

Leckey and Ward suggest that federal securities legislation could draw support from section 91(15), the federal banking power. They point to the developing nature of the financial industry (banks, insurance companies, trust companies and brokers) and in

particular to the acquisition by the banks of the major brokerage houses as their subsidiaries. The current *Bank Act* authorizes banks to carry on certain securities-related business (for example, investment counselling services and portfolio management services).

In my view, however, the banking power would not provide support for federal securities legislation.

First, the fact that federal banks may have purchased brokerages does not make those brokerage activities part of "banking" for constitutional purposes.

Second, the banking power is intended to deal with the activities of the institutions created by Parliament as banks (see *Canadian Pioneer Management Ltd. v. Labour Relations Board of Saskatchewan*, [1980] 1 S.C.R. 433). It would not give jurisdiction to regulate the activity of non-banks in the securities markets.

Third, none of the limited number of cases on the scope of the banking power has suggested that it extends so broadly. The cases have involved activities which are part of the general understanding of "banking" or are integrally related to banking activities.

(d) Interdelegation

The courts have been generally approving of various forms of cooperative federalism. In *Re Agricultural Products Marketing Act*, [1978] 2 S.C.R. 1198, Pigeon J. at page 1296 expressed his desire to uphold, if possible, a sincere cooperative effort between the federal and provincial governments.

The one exception is that it is not possible for Parliament or the provincial legislatures to delegate their legislative authority to each other. In *Attorney General of Nova Scotia v. Attorney General of Canada*, [1951] S.C.R. 31, Kerwin J. said:

> The *British North America Act* divides legislative jurisdiction between the Parliament of Canada and the Legislatures of the Provinces and there is no way in which these bodies may agree to a different division.

At least four cooperative arrangements are possible: administrative delegation, from one level of government to an administrative body of the other level of government; incorporation by reference of the legislation of another level of government; conditional legislation, whereby the legislation of one level of government does not come into effect without (for example) the approval of another level of government; and mirror legislation, where there is concurrent jurisdiction and the federal and provincial governments pass essentially identical legislation.

Administrative interdelegation was approved by the Supreme Court of Canada in *PEI Potato Marketing Board v. Willis*, [1952] 2 S.C.R. 392. Parliament could validly delegate authority to a provincial marketing board to establish marketing schemes for interprovincial trade in agricultural products. The court approved of an arrangement under which the federal government adopted as its own an agency already authorized under provincial law.

Similarly, a provincial body could exercise authority pursuant to regulations under the federal *Fisheries Act* to license commercial fishermen (*Peralta v. Ontario*, [1988] 1 S.C.R. 1045), and the provincial attorneys general could exercise a discretion conferred by the Criminal Code with respect to the application of alternative measures programs for youth offenders (*R. v. S.(S.)*, [1990] 2 S.C.R. 254).

Incorporation by reference has been approved with respect to gaming regulation. Parliament has jurisdiction over offences connected with gaming, while the provinces have jurisdiction to license and regulate gaming activities. The Criminal Code provisions contemplated lottery licensing schemes being established by a provincial lieutenant governor in council. In *R. v. Furtney*, [1991] 3 S.C.R. 89, it was held that this was not a delegation of federal legislative authority but an incorporation by reference of provincial legislation authorizing the lieutenant governor in council to issue lottery licenses. The court considered that, in the exercise of its powers generally, Parliament was free to define the area in which it chose to act and, in so doing, might leave other areas open to valid provincial legislation.

Furtney also illustrates the use of conditional legislation. The federal exemption from criminal sanction was conditional upon provincial action. This was valid.

Finally, mirror legislation has been used to implement federal-provincial agreements. One example is the parallel federal and provincial legislation implementing the accord between Canada and Nova Scotia over offshore development.

Any of these forms of delegation is, of course, revocable. An irrevocable delegation would be inconsistent with the very concept of delegation, and would amount to a body with authority under the Constitution transferring that constitutional authority to another body, permanently and by its own act.

The requirement that such delegation be revocable has been commented on in a number of the cases. In *Furtney*, the Court said:

> The delegate is, of course, always subordinate in that the delegation can be circumscribed and withdrawn.

Similar recognition can be found in *Coughlin v. Ontario (Highway Transport Board)*, [1968] S.C.R. 569; *Peralta*; and *Attorney General of Ontario v. Scott*, [1956] S.C.R. 137.

In summary, the provinces could incorporate the federal legislation by reference, and delegate administrative powers to the CSC. They could also, of course, dissolve regulatory bodies they had previously established. In the case of the territories, Parliament has the original jurisdiction in any event.

2. If one or more provinces or territories decides not to enact the legislation described above, and the federal government concludes that this would jeopardize the successful operation of the scheme in other parts of the country, would the federal government nevertheless have the legislative authority to implement the CSC model on a national basis by including in its legislation an express paramountcy clause that plainly demonstrates an intention to enact a complete code and which states that federal legislation alone would govern, to the exclusion of provincial and territorial regulation, on prescribed matters, including amongst other matters: (a) prospectus review; (b) registration of market intermediaries; (c) take-over bid regulation; (d) continuous disclosure by public companies; (e) prospectus exempt financings; (f) international securities agreements; and (g) securities regulatory enforcement actions?

I will discuss the general application of the doctrines of paramountcy and interjurisdictional immunity, before considering the effect of an express paramountcy clause of the type proposed.

If the federal legislation is upheld under the trade and commerce power, then the provinces have in practice concurrent jurisdiction to pass legislation which will be operative unless there is an operational conflict with the federal legislation, in which case the federal legislation will apply by operation of the doctrine of paramountcy.

If the federal legislation is upheld on the basis of peace, order and good government, then it is more likely that the applicable doctrine for determining the role of any provincial legislation would be the doctrine of interjurisdictional immunity. Under the national concern branch, the exclusive federal jurisdiction is of a plenary nature and extends to intraprovincial aspects.

The principle of paramountcy says that when there is a conflict between valid federal and provincial legislation, the provincial legislation is constitutionally inoperative with respect to the person or conduct dealt with by the federal legislation.

The test for the application of the principle of paramountcy has undergone a subtle change. The classic modern statement of paramountcy has been that given in *Multiple*

Access Ltd. v. McCutcheon, [1982] 2 S.C.R. 161, where Dickson C.J.C. said that both the federal and provincial legislation should be allowed to operate unless there was an operational conflict between them. That remains the test. However, there has been a shift in the way the test is applied. In *Multiple Access*, Dickson C.J.C. said:

> In principle, there would seem to be no good reasons to speak of paramountcy and preclusion except where there is an actual conflict in operation as where one enactment says "yes" and the other says "no"; "the same citizens are being told to do inconsistent things"; compliance with one is defiance of the other.

Some recent cases use the same language: see *114957 Canada Ltée (Spraytech, Société d'arrosage) v. Hudson*, [2001] 2 S.C.R. 241, 2000 SCC 40. However, the growing tendency is for the courts to adopt a more flexible approach which takes into account not just the wording of the two statutes but their purposes. This had its origin in the judgment of La Forest J. in *Bank of Montreal v. Hall*, [1990] 1 S.C.R. 121, in which he said that he would not find the necessary conflict in operation unless the effect of the provincial legislation was to frustrate the legislative purpose of Parliament. This approach was then adopted and applied in *Law Society of British Columbia v. Mangat*, [2001] S.C.R. 113, 2001 SCC 67. In *Mangat*, the federal *Immigration Act* permitted a person to be represented before an inquiry by an adjudicator or in any other proceedings before the Refugee Division by "a barrister or solicitor or other counsel". The court held that "other counsel" must mean persons other than those licensed to practice law under provincial legislation and there was thus a conflict between the federal and provincial statutes. The provincial legislation frustrated the legislative purpose of Parliament, which was that certain persons should be able to appear before the immigration tribunals. The provincial legislation was therefore constitutionally inoperative.

The principle of interjurisdictional immunity is described in *Ordon Estate v. Grail*, [1998] 3 S.C.R. 437 at para. 81 as follows:

> As a general matter within the Canadian federal system, it is constitutionally permissible for a validly enacted provincial statute of general application to affect matters coming within the exclusive jurisdiction of Parliament. The principal question in any case involving exclusive federal jurisdiction is whether the provincial statute trenches, either in its entirely or in its application to specific factual contexts, upon a head of exclusive federal power. Where a provincial statute trenches upon exclusive federal power in its application to specific factual contexts, the statute must be read down so as not to apply to those situations. This principle of statutory interpretation is known perhaps most commonly as the doctrine of "interjurisdictional immunity".

The principle of interjurisdictional immunity does not serve to protect the entire area of federal jurisdiction in question. As expressed by Beetz J. in *Bell Canada v. Quebec*, [1988] 1 S.C.R. 749 at 762, the immunity applies to the truly federal aspects of a head of power. The point is expressed in *Ordon Estate* at page 497 by referring to "the principle that each head of federal power possesses an essential core which the Provinces are not permitted to regulate indirectly".

The cases are not entirely consistent as to when it is appropriate to apply paramountcy and when interjurisdictional immunity. For example, the Ontario Court of Appeal in *R. v. Lewis* (1997), 155 D.L.R. (4^{th}) 442, applied the principle of interjurisdictional immunity and found that the provincial legislation dealing with the licensing of accountants did not apply to federal electoral legislation permitting "accountants" to deal with election financial reports. The Supreme Court of Canada in *Mangat* approved this result but suggested it could more appropriately have been achieved by application of the doctrine of paramountcy.

In *Mangat*, the court said that it was appropriate to apply paramountcy as the subject matter (immigration) was one which had a double aspect. The court also showed some preference for the use of paramountcy, describing it as the more supple doctrine.

The area of securities regulation is one which has been found to have a double aspect. In *Smith*, Kerwin C.J., after referring to the provisions in the Criminal Code and in the Ontario securities legislation which both dealt with prospectuses, said:

> Parliament undoubtedly had power to enact s. 343 of the Criminal Code, but a prospectus may in one aspect and for one purpose be the subject of valid provincial legislation, while, in another aspect and for another purpose, it may be the subject of valid federal legislation: *Provincial Secretary of Prince Edward Island v. Egan.*

This passage was relied on by Dickson C.J.C. in *Multiple Access*, who also found that the double aspect doctrine was applicable. In that case, the federal and provincial statutes both dealt with insider trading. After referring to the views of Professor Ziegel that securities legislation clearly has a double character and that there is no simple dichotomy between legislation of a company law character and legislation affecting property and civil rights in the province, and having referred to Professor Lederman's test for double aspect, he said:

> The double aspect doctrine is applicable, as Professor Lederman says, when the contrast between the relative importance of the two features is not so sharp. When, as here, the corporate-security federal and provincial characteristics of the insider trading legislation are roughly equal in

> importance there would seem little reason, when considering validity, to kill one and let the other live.

Given the recognized double character of the area, and given my earlier conclusion that it is most likely that comprehensive federal securities legislation will be upheld under the trade and commerce power, I conclude that the courts would deal with the overlap between the federal and provincial legislation through the application of the "more supple" doctrine of paramountcy.

In my view, the courts will apply the more modern test for conflict and ask whether the provincial legislation frustrates the legislative purpose of Parliament. I do not think that the courts will find this an easy question to resolve.

On the one hand, there is the desirability of upholding the benefits of a federal securities regime, which promises more comprehensive coverage, uniformity and greater simplicity.

On the other hand, the courts have for 70 years repeatedly recognized the valid provincial concern over the protection of the public within each province.

I do not think that the past history of cases concerning potential conflicts will be determinative, but it is certainly true that the courts have, historically, tried to accommodate both federal and provincial legislation in the area of securities regulation. In the majority of the cases, there was some federal legislation in question, but the provincial legislation was almost invariably found to be both valid and applicable (or operative). For example:

(a) *Lymburn v. Mayland*: a dominion company is subject to provincial law as to the business of all persons who trade in securities. The company therefore had to issue its capital using a provincially licensed broker.

(b) *Smith*: there was no conflict between the Criminal Code false prospectus provision and a provincial securities provision which prevented trading until a prospectus containing full disclosure had been filed and created an offence in relation to the making of a material for false statement in any such prospectus.

(c) *Duplain v. Cameron*: provincial securities legislation which regulated trading in promissory notes did not offend the federal power in relation to bills of exchange or conflict with the federal legislation.

(d) *Re Williams and Williams* (1961), 29 D.L.R. (2d) 107 (Ont. C.A.): provincial securities legislation which provides for the appointment of a person to investigate trading in securities does not encroach on the field of criminal law. A similar approach was taken by the B.C. Court of Appeal in *International Claim Brokers Ltd. v. Kinsey* (1966), 57 D.L.R. (2d) 357.

(e) *Multiple Access Ltd. v. McCutcheon*: provincial securities legislation respecting insider trading was intra vires and did not conflict with the similar provisions of the *Canada Corporations Act*.

I think it would be extremely unlikely that the courts will conclude that Parliament's legislative purpose requires the inoperability for all purposes of provincial securities legislation. This would, in effect, create an exclusive federal head of power.

It is not impossible that the courts will take a very broad view of the purpose of the federal legislation and render the majority of provincial regulation inoperative. However, I do not think this is the most likely result. I think it is more likely that the courts will engage in a balancing exercise. The Supreme Court of Canada has explained that it is necessary to strike a balance when defining the scope of the federal trade and commerce power and the provincial power over property and civil rights (see, for example, the *General Motors* case).

In my view, it is likely that the courts will find that at least a significant part of provincial securities legislation remains operative. Without having two sets of legislation to compare, it is very difficult to offer any precise predictions as to which provincial provisions would remain operative. The likely areas include provincial legislation relating to the following matters: securities which are in substance interests in real estate in the province; the licensing and conduct regulation of dealers in the province; matters related to provincial company law, including share structure, rights attached to shares, insider trading, corporate governance and takeovers; private offerings of shares within the province; and perhaps (though more doubtfully) public trading of shares within the Province.

In summary, federal legislation enacting the CSC model would be effective to exclude provincial securities regulation to the extent that a court was satisfied that Parliament's legislative purpose would be frustrated by the continued operation of provincial securities legislation.

You have asked me to consider the effect of an express paramountcy clause which would show that Parliament intended the legislation to be a complete code and which would expressly state that the federal legislation would govern a number of prescribed matters to the exclusion of provincial and territorial regulation. The prescribed matters would

include prospectus review; registration of market intermediaries; takeover bid regulation; continuous disclosure by public companies; prospectus exempt financing; international securities agreements; and securities regulatory enforcement actions.

I am not aware of any judicial consideration of an express paramountcy clause of this type.

In my opinion, such a clause would not, by itself, automatically exclude the operation of provincial legislation. A clause which clearly expressed Parliament's intention to enact a comprehensive code and oust provincial and territorial securities legislation would undoubtedly be taken into account by the courts, and would make it more likely that the courts would apply the paramountcy principle.

However, an express paramountcy clause would not exclude the need for the court to consider the substance of the federal legislation and to form its own conclusion on the paramountcy question. The court could not allow Parliament to control its own jurisdictional reach by a bare legislative assertion.

Yours truly,

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The Relationship between Financial Markets and Economic Growth: Implications for Canada

Research Study Prepared for the
Wise Persons' Committee

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The Relationship between Financial Markets and Economic Growth: Implications for Canada

Executive Summary

The financial sector has experienced significant change over recent decades, driven by advances in information and communications technology and widespread reductions in international barriers to trade and investment. International integration is advancing rapidly, reflecting in part the development of global production chains and the rapid growth of emerging market economies. As a result of the forces of integration, international competition has become more fierce and firms are under increasing pressure to cut costs and differentiate their products to survive.

Canada's economy has numerous linkages beyond its borders, particularly with the United States. The future improvement of Canadians' standard of living will depend in large part on foreign investment in Canada and the ability of Canadians to invest abroad. In this regard, a thriving financial sector will be a key component of our success.

Canada has a small share of the global capital market. Thus, to be competitive, the Canadian capital market must be efficient and offer a low cost of capital. As much as possible, the policies and institutions that govern the Canadian financial sector should be harmonized to international standards. Made-in-Canada policies risk dampening or distorting international investment flows and should exist only where there is a demonstrable domestic imperative.

Economists' understanding of the role of financial systems as a driver of long-term economic growth has evolved considerably in recent years. Financial systems are recognized to affect growth through five main channels that determine the accumulation and allocation of capital. Countries with efficient financial systems are able to better harness their long-term growth potential.

Regulation is a key component of financial systems. The need for regulation reflects the inherent feature of asymmetric information in financial markets. Regulation is needed to protect investors, promote efficient capital markets, and enhance confidence. Regulators are challenged to balance the needs of investor protection (which may lead to more stringent regulation) with the need to promote market efficiency (which may lead to minimal government interference in markets).

The rapidly changing global financial environment complicates the task of regulators. Advances in information and communications technology, particularly the internet, create more competition for domestic financial service providers from international sources. They also give rise to new potential threats to investors.

The objective of regulation is to foster a domestic market that enjoys domestic and international confidence and a competitive cost of capital. If Canadian capital markets are to be a preferred destination, the policy environment that defines them must be both efficient and effective.

The Relationship between Financial Markets and Economic Growth: Implications for Canada

"Finance is, as it were, the stomach of the country, from which all the other organs take their tone."

– William Gladstone, 19th Century British Prime Minister

1. Introduction

The financial sector is at the forefront of the increasingly integrated knowledge-based economy. The traditional banking, insurance and securities industries have experienced dynamic change during the past thirty years driven by advances in information and communications technology that have facilitated the movement of money into a global activity. Capital now flows across most borders in tremendous volume with speed and ease. New services and products have proliferated and new players challenge the traditional service providers. Intensifying competition among service providers has created inexorable pressures to reduce costs and differentiate products.

These forces of change have been profound and will continue to reshape the international economy in ways that are difficult to predict. They are constantly giving rise to new opportunities to enhance productivity and increase standards of living. However, as with all economic endeavours, changing circumstances introduce new risks that must be managed by both market participants and public policy authorities alike. The increasing complexity of international markets has led to a proliferation in the kinds of risk confronting markets. As a result, international finance is increasingly driven by risk evaluation and control.

Risk arises in the financial sector in large part because of the fundamental feature of *asymmetric information*. Simply put, providers and users of the funds each have some knowledge that the others do not. Borrowers have unique information about the viability of the projects they undertake and their ability to repay loans. Lenders channel their savings in part through financial institutions and do not have complete information about how their money is managed. Asymmetric information can distort investment decisions and create opportunities for unscrupulous market participants to manipulate and exploit others. It is the goal of regulators to offset the negative consequences of this feature of markets. In the context of international markets, this task is increasingly challenging.

While business is conducted increasingly across borders, regulation of financial sector activities and institutions remains primarily the domain of national regulators.[1] Increasingly, regulators have to catch up with market-driven pressures for consolidation

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1 National regulators co-operate and share information in international fora such as the International Organisation of Securities Commissions (IOSCO), the Bank for International Settlements (BIS), the Financial Stability Forum (FSF) and others. These groups are working to harmonize rules and standards internationally, although their efforts have a long way to go.

in the financial services sector and cross-border operations. One of the implications is that the drivers of change have shifted power and relationships away from the traditional financial services providers to consumers. More and more individuals have a significant portion of their wealth linked to capital markets, either through direct stock ownership or indirectly through mutual funds and pension plans.

Another implication is that as the effects of these changes become better understood, mainstream economists are coming to understand that the financial sector is not a "hand maiden" of growth as it was viewed thirty years ago, but that a sound, well functioning financial sector with efficient institutions is a significant determinant of an economy's long term growth prospects.

The purpose of this paper is to summarize the forces of change and the scale that the international integration of capital markets has reached (Section 2), the logic and evidence behind the mainstream view of the finance-growth link (Section 3), and what this means for regulation of capital markets in general and for Canada in particular (Section 4). Section 5 offers some concluding thoughts.

2. The Integration of Global Markets

The forces of integration at play in the international economy are deep and pervasive (see Box 1). Several key developments in recent decades have transformed the way domestic economies function. These include the large global shift to market-based economic systems following the fall of the Berlin wall, the lowering of barriers to trade and investment, rapid technological progress, and the increase in specialized production methods. These forces have caused product and capital markets to become increasingly interconnected and interdependent.

This environment of enhanced competition has left some inefficient producers behind, while others have transformed their way of doing business and thrived. Throughout the economy, producers and consumers have seized upon the new opportunities that are available in a global market.

Open, competitive markets provide consumers with unprecedented access to a vast range of low-cost goods and services, which enhances their standards of living.

Savvy entrepreneurs increasingly look beyond their national borders for new markets and sources of production inputs in their quest for greater profits. Nowhere is this more true than the financial services sector, where international competitive forces have fundamentally reshaped the industry. Indeed, the leading financial service firms are truly global in scope.

Over the last twenty years, while technology has made the world a smaller place, political developments have made the global marketplace much bigger. The fall of the Soviet Union and end of the cold war, the re-emergence of democracy in Latin America,

and rapid growth of emerging market countries in East Asia have brought a third of the world's population into the global market place. Of the five billion people that live in the developing world, approximately three billion now live in countries defined by the World Bank as "globalizers".[2] These are countries that have been able to tap the benefits of increasing integration and increase their standards of living by accessing the markets of developed countries.

Asia's performance in this respect has been particularly impressive. Asia's contribution to global output has doubled since 1950 and accounts for one-fifth of global exports and one third of total foreign direct investment (FDI) flowing to emerging market countries.[3] China is emerging as a potential economic juggernaut. Looking ahead, several other emerging countries, including India, Turkey and Indonesia, have the potential to generate similar rates growth if they successfully implement the right mix of economic policies. Thus, there are "more players in the game" today, and more are poised to join.

BOX 1: Evidence of Increasing International Integration

The evidence of the rapid pace of international financial integration over the last decade alone is impressive. Consider the following;

- Global exports totalled about US$ 6.4 trillion in 2002, a 70 per cent increase from 1992. Over the same period, global inflows of foreign direct investment increased more than two-fold to US$ 384 billion from US$ 141 billion. By comparison, global output grew by only 34 per cent over the same period.
- Outstanding international debt securities worldwide were US$ 10.3 trillion in mid-2003, a ten fold increase from the level in 1987.
- Global international equity issues quadrupled between 1992 and 2002 to US$ 103 billion. Prior to the recent decline in global equity markets, they had reached a peak of US$ 317 billion in 2000.
- Daily turnover in foreign exchange markets was US$ 1.2 trillion in 2001, up from US$ 590 billion in 1989. Daily turnover reached a recent peak of US$ 1.5 trillion in 1998.
- Crossborder transactions in Canadian equities grew to 38 per cent of GDP in 2002 from 5 per cent in 1990.

Sources: BIS, IMF, World Bank, Statistics Canada.

The barriers separating these players have also become more porous in recent decades, sharpening competition. Since the end of World War II, recognition of the benefits of integration has encouraged the trend toward lower barriers to trade and investment in both the developed and developing world. Indeed, trade and capital flows have risen much more rapidly than global gross domestic product (Chart 1).

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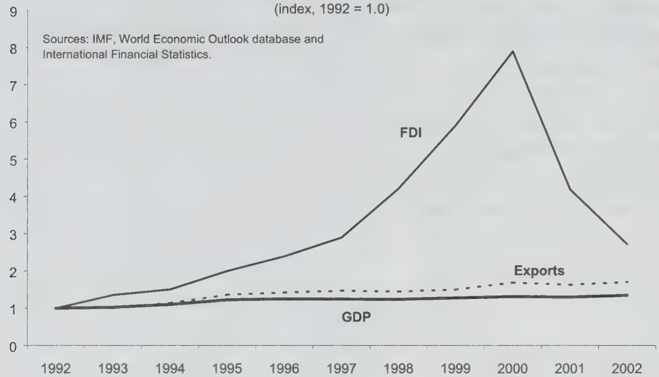
2 World Bank, "Globalization, Growth and Poverty: Building an Inclusive World Economy" (December 2001).

3 Horst Kohler, Managing Director of the IMF (September 3, 2003), online at http://www.imf.org/external/np/speeches/2003/090303.htm.

Chart 1
Global GDP, Exports, and FDI
(index, 1992 = 1.0)



The growth in global exports reflects a number of factors. As with capital flows, advances in communication and transportation technologies have lowered the costs of trading internationally. Meanwhile, rising incomes and the elimination of barriers to trade boost demand for imports, particularly of intermediate goods.

The World Trade Organization (WTO) continues to work toward lower global tariff and non-tariff barriers to trade. Bilateral and regional trade agreements, such as the North American Free Trade Agreement (NAFTA), have provided additional stimulus to trade flows and the specialization of production. In Canada, the 1988 Free Trade Agreement with the U.S., followed five years later by NAFTA, ushered in a period of unprecedented export growth. As a result, exports grew as a share of GDP throughout the 1990s as producers took advantage of access to a larger market (Chart 2).

Chart 2
Canadian Exports as a Share of GDP

Global trade is also boosted by the emergence of new global suppliers offering competitive goods and services, and the creation of global supply chains in manufacturing. Economies increasingly specialize production according to their comparative advantage and import goods that are more competitively produced abroad (e.g. the U.S. imports household electronics from Asia rather than producing them domestically).

Moreover, advanced methods of production, such as "just in time delivery", take advantage of low transportation costs and international sources of production, resulting in increased international commerce. For example, North American automobile production is highly integrated, with components crossing back and forth over the Canada-U.S. border as much as three times during the production process. Specialization of this kind is an increasingly prevalent feature of the modern economy, which generates significant cross-border commerce and capital flows.

Robust trade contributes to increased capital flows, reflecting the demand for foreign exchange, export credit, and hedge instruments. Indeed, international private capital flows dwarf the volume of international trade and the sharp increase in these flows has been a defining feature of international economy over the past two decades. Gross global capital flows ballooned from US$ 622 billion in 1980 to nearly US$ 4 trillion in 2000 (Chart 3).[4] That translates to roughly US$ 10 billion of capital flowing across international borders every day.[5]

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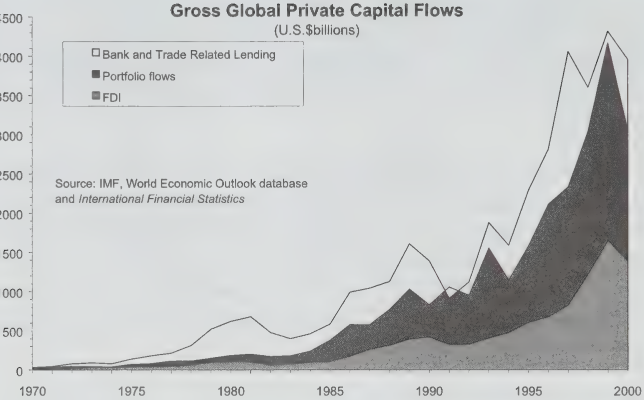
4 Gross private capital flows are defined as the sum of the absolute value of both inflows and outflows of private capital. This excludes official government transfers (e.g. foreign aid) and flows from international financial institutions. Gross capital flows are used as a measure of the volume of international transactions, whereas the net capital flows of a particular country reflect its net foreign financing needs.

5 The volume of capital flows declined over the second half of the 1990s, reflecting the effects of a number of financial crises in emerging market countries (Mexico in 1994, East Asia in 1997, Russia in 1998, Brazil in 1999) as well as the bursting of the U.S. tech bubble in 2000, which ushered in a period of slower global growth. Nevertheless, a rebound in global growth is likely to reinvigorate capital flows.

Chart 3
Gross Global Private Capital Flows
(U.S.$billions)



Capital will flow to where it can obtain the highest risk-adjusted return. This is true for both FDI and portfolio investment in stocks, bonds and money market instruments. Portfolio theory demonstrates the benefits of diversifying across the widest possible non-correlated set of assets. Thus, as information and communications technology has advanced, capital increasingly flows internationally without regard for national borders.

The increase in FDI reflects firms' greenfield investments abroad, as well as mergers and acquisitions with foreign operations.[6] The new opportunities in emerging market economies, the reduction in barriers to foreign investment and the advances in communication and transportation technology have spurred this investment, as producers are attracted to local comparative advantage and untapped productive capacity.

Policies restricting international capital flows have changed in advanced countries too. For example, in the mid-1980s, Canada replaced the Foreign Investment Review Agency with Investment Canada in an effort to signal a more welcoming attitude to foreign investment. Thus was followed by the free trade agreements and the elimination of other restrictions to foreign direct participation in the Canadian economy (e.g. foreign bank restrictions were most recently eased in 1999).

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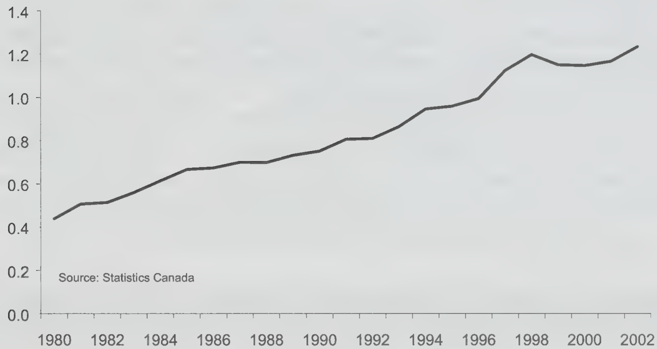
6 The strong surge and decline in global FDI at the end of the 1990s (Chart 1) largely reflects the speculative Asian bubble, which resulted in a painful but necessary correction. Nevertheless, there is a clear upward trend in FDI over the period.

As a result of these forces of integration, both inward and outward FDI in Canada rose sharply through the 1990s, although the recent global economic slowdown has slowed investment in both directions. In particular, Canadian firms have actively invested abroad to take advantage of newly accessible markets and extend their global supply chains. Indeed, after a long history as a net recipient of FDI from abroad, Canada shifted to become a net outward investor of FDI in the 1990s (Chart 4).

Chart 4
Ratio of Canadian Outward FDI Stock to Inward FDI Stock



FDI is one of the core drivers of international integration and contributes to growth in portfolio flows and interbank claims, as firms increasingly meet their financing needs from international sources.

New securities markets in emerging market countries have further spurred international portfolio diversification. In particular, throughout the late 1980s and 1990s, emerging market countries liberalized their controls on capital inflows and outflows to access foreign savings and thus speed development. At the same time, a large, new emerging market capital market was created in the 1980s when "Brady bonds" were devised and issued as a mechanism to restructure sovereign debt held by commercial banks. This created a deep secondary market in the OECD countries whose mutual funds and pension plans hold and trade emerging market countries' securities.

Rapid advances in information and communications technology have also contributed to the sharp increase in international capital flows. The internet and other communications technologies allow information to be shared instantaneously at low cost. Global financial market participants make optimal use of cutting-edge technology for modern portfolio and risk management. Technology and the mobility of capital allow financial service providers to support an international client base. As a result, companies and consumers can access financial services from providers anywhere in the world at highly competitive prices. The OECD and WTO are very active in promoting even freer trade in financial services, recognizing the potential benefits of expanded markets, specialization, and economies of scale.

In summary, today's investor has a wide spectrum of choices for investing his or her savings. Through the proliferation of mutual funds and derivative instruments, more people than ever before have a portion of their wealth invested in international markets. From the borrowers' perspective, issuers of securities can access international capital to fund their investment projects and can obtain financial services from anywhere in the world. Borrowers can issue securities in domestic capital markets in the hope that foreign buyers will come to them. Alternatively, domestic issuers can place their securities in foreign capital markets. Ultimately, the cost of capital is the key determining factor.

The Canadian Capital Market

As a global player, Canada's share of the international capital market is small, estimated at approximately 2 per cent (Table 1). Thus, Canada is subject to international financial market developments, but does not have much weight in influencing them. Canada's financial sector is increasingly oriented to the international market and subject to competitive pressures from abroad, as well as from new domestic service providers. The implication for policy is that made-in-Canada obstacles could dampen or distort international investment flows, thereby raising the cost of capital for Canadian firms and limiting the available investment portfolio for Canadian savers.

Table 1: World and Canadian Capital Markets

	Stock Market Capitalization	Debt Securities (Public)	Debt Securities (Private)	Bank Assets
World (US$ billion)	28,875	22,157	19,635	79,402
Canada (US$ billion)	697	530	314	1,147
Canada's Share (%)	2.4	2.4%	1.6%	1.4%

Data for 2001. Source: Global Financial Stability Report, IMF

Canadian banks have traditionally had extensive foreign operations, but are increasingly adopting a North American market strategy involving wealth management, corporate and investment banking, and electronic banking.[7] In 1999, the rules governing foreign banks operating in Canada were eased, sparking a new wave of domestic competition. As well, competition from domestic and foreign "monoline" companies, which specialize in a single product such as credit cards or mortgages, are creating new challenges for traditional suppliers. For example, MBNA, a specialized U.S. bank, is now the largest independent credit card lender in the world, with operations in Canada.

7 Fred Daniel, "Recent Changes to Canada's Financial Sector Legislation" (Winter 2002-2003) Bank of Canada Review 4.

The Canadian insurance industry is also more internationally oriented. For example more than one-half of the income of Canadian life-insurance companies stems from foreign sources, compared to one-third in 1990.[8]

The Canadian securities industry also has extensive international connections, particularly with U.S. markets, reflecting the interconnectedness of our economies. However, there are some restrictions on foreign competition in the domestic market. Presently, Canada is one of only a few OECD countries that require a domestic commercial presence by foreign securities service providers.[9]

By size of stock market capitalization, Canada's stock market is ranked 6th in the G-7, according to data for 2000.[10] This rank is likely to slip over time, given the rapid expansion of capital markets in several emerging market countries, notably China.

A significant number of Canadian firms raise equity capital outside of Canada, although Canada accounts for only a small share of international equity issues (Table 2). The number of firms interlisted on both Canadian and U.S. exchanges increased over the first half of the 1990s, but has since declined slightly. Nevertheless, 50 of the 60 biggest companies listed on the TSX are interlisted on a U.S. exchange.[11]

Table 2: Announced International Equity Issues
(US$ billions)

	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
Canada	0.8	0.5	1.8	1.7	4.3	0.9	6.7	6.9	4.2	5.5
World	44.5	63.3	54.6	84.0	119.8	127.8	216.8	317.7	149.6	103.8

Source: BIS, International Financial Statistics

Although gross private capital flows in and out of Canada have more than doubled over the past decade, rising from $44.3 billion in 1992 to $91.6 billion in 2002, Canada's share of gross global capital flows has not changed much over the past decade. Canada's share of global FDI inflows has increased, mainly reflecting U.S. investment, but was offset by a decline in our share of global portfolio capital inflows (Chart 5).

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8 *Ibid.*

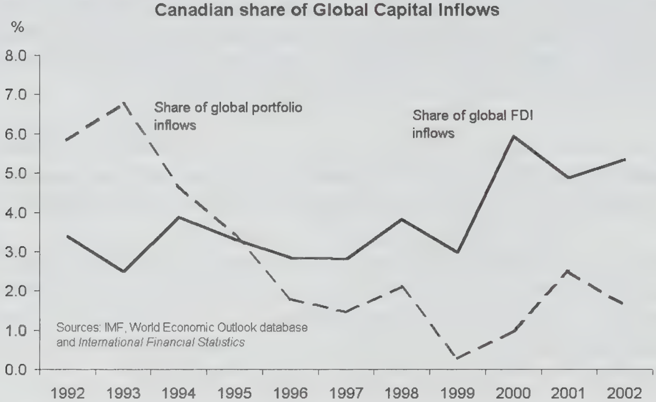
9 The other countries with this restriction are Japan, Belgium, Mexico, Norway and Turkey. However, Ontario relaxes this restriction in the case of sophisticated investors. OECD "Cross-Border Trade in Financial Services: Economics and Regulation" (March 2000) 75 Financial Market Trends.

10 The Economist, "World in Figures" (2003).

11 Charles Freedman and Walter Engert, "Financial Developments in Canada: Past Trends and Future Challenges" (Summer 2003) Bank of Canada Review.

Canada accounts for a declining share of the international purchases of stock, bonds and other securities. Indeed, had we maintained our global share of these purchases at 1992's level, Canada would have realized an additional $35 billion of portfolio inflows in 2002.

Chart 5
Canadian share of Global Capital Inflows



No single factor accounts for this foregone share of portfolio inflows to Canada. Part of the decline reflects the drop in demand for foreign savings from Canadian governments as they consolidated their fiscal positions over the decade. As well, the strong U.S. demand for foreign capital to finance large current account deficits has absorbed inflows from other regions.

Some evidence suggests that Canadian markets are having increasing difficulty tapping into foreign demand for portfolio investment. Since 1990, as international portfolios have become increasingly integrated, foreign purchases of Canadian stocks have risen much more slowly than Canadian purchases of foreign stocks (Chart 6). Given Canada's strong economic performance and solid prospects for future growth, the muted foreign interest in Canadian equity markets is somewhat of a puzzle. In this regard, regulation of Canadian financial markets may be less efficient than it could be, which in effect taxes capital market activity in Canada.[12]

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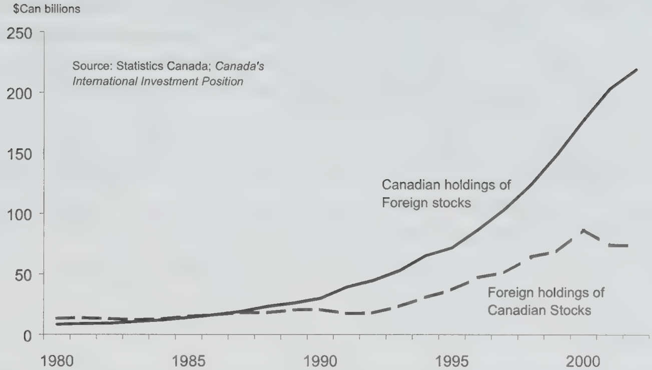
12 *Ibid.*

Chart 6
International Holdings of Stock



3. Financial Systems and Economic Growth

Sophisticated financial systems are now seen as a defining feature of the advanced economies – but this was not always the case. Economists' understanding of the nature of the relationship between financial systems and economic growth has evolved over time. One of the earliest to write on this issue was Walter Bagehot in his book *Lombard Street: A Description of the Money Marke*t (1873). At the height of British industrial power, he wrote that what separated England from "all rude countries" was the ability of its financial markets to mobilize savings to finance "immense works". Bagehot was the first to define the two primary roles of financial markets. First, they facilitate the *accumulation* of capital. Second, they *manage risk* inherent in particular investment projects and industries.

Later, several prominent economists acknowledged that financial systems were a hallmark of an advanced economy, but argued that they did not in and of themselves contribute to growth. For example, Joan Robinson argued that financial systems emerge in a passive way that responds to the needs of the real economy. Her view was neatly expressed in the quote, "where enterprise leads, finance follows".[13] Early empirical work appeared to confirm that economic growth and financial development occurred in tandem, with no compelling evidence of a causal relationship.[14]

A general acceptance of this view over the 1950s to 1970s helps explain why the role of the financial sector was essentially absent from the early literature on development. Academics and policy makers in this period believed that finance emerges

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13 Joan Robinson, "The Generalization of the General Theory" in *The rate of interest, and other essays* (1952).

14 For example, see Raymond Goldsmith, *Financial Structure Development* (1969).

in an economy only after a country reaches a certain stage of development. To the extent that the financial sector was addressed in the early development literature, it was often to advocate the deliberate manipulation of financial markets to achieve particular societal goals. For example, developing countries were often encouraged to favour the flow of credit to preferred industries, through credit rationing or interest rate caps, with the result that other productive endeavours were left to languish.

The ultimate failure of these strategies – dubbed "financial repression" by McKinnon[15] – contributed to the growing realization of the central role played by financial systems in developing and developed economies alike. Today, the development strategies promoted by the main international financial institutions (IFIs) – the World Bank and IMF – stress the fundamental importance of sound institutions and public policies that support the strengthening of domestic financial systems in developing countries.

Economists' understanding of the role of financial systems in advanced economies has evolved as well. Modern growth theory is rooted in the work of Robert Solow, which conceptualizes a production function based on labour, capital and the use of technology. The contribution of labour and capital to output in this model is characterized by diminishing returns. For a given labour force, incremental amounts of capital produce ever-smaller gains in output. The same is true for incremental amounts of labour for a given amount of capital stock. Thus, after a certain point, the return from additional capital investment and additional labour will be less than their costs, bringing the growth process to a stop.[16] The key to growth in this model is continuous productivity advances through technological advancement. In this way, gains in productivity exceed diminishing returns, making productivity the main engine of growth.

Early growth models assumed technological gains to be largely exogenous events. Since then, economic theory has evolved to focus on the determinants of productivity growth – now understood to be the foundation of long term economic growth. Models of this kind are termed "endogenous growth models", because the factors that drive productivity gains and the growth process are incorporated within the model parameters. We now have a better understanding of some of the factors that drive productivity. Many of these factors relate to the structure of the economy, including its institutions, which influence the rate of technological advancement that spurs productivity growth. In this way, the structure of the economy itself propels growth.

This leads us back to finance and financial systems. The relationship between finance, financial systems and growth is also better understood. Robert Levine has been at the forefront of those who argue one of the key structural factors that affects

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15 Ronald McKinnon, *Money and Capital in Economic Development* (1973).

16 Some growth models get around this problem by assuming that capital has constant returns to scale. That is, additional units of capital continue to produce the same amount of gain in output.

productivity is the financial system.[17] The notion that the financial system affects productivity is not new. In his 1912 book, Joseph Schumpeter noted that banks' ability to identify and fund successful entrepreneurs promotes technological advancement. However, this view had since fallen out of mainstream discourse.

Levine's innovation was to consider financial services as affecting economic growth through five main channels, described below. By considering the functions of the financial sector in a comprehensive manner, Levine is able to demonstrate a significant role for financial markets that was not present in earlier models that used a narrower definition (e.g. Goldsmith (1969)). A large body of empirical literature on this subject has emerged over the past decade, which provides considerable support for Levine's hypothesis.[18]

Financial markets come into existence because of a basic characteristic of markets: asymmetric information. Information that could have implications for investment decisions is not uniformly available and is costly to obtain for individuals (in terms of money, as well as time and effort). In general, financial markets facilitate the gathering of information and lower the transaction costs of interactions between savers in the economy and borrowers. The functions of the financial system have a direct effect on growth and productivity. As a result, this approach is often called the functional view. The impact on economic growth occurs through five main channels:[19]

Savings mobilization: Savings mobilization is the most fundamental function of capital markets. Individual savers typically cannot fund borrower needs completely. Financial markets pool the savings of households and make the funds available for investment. The scale of this exercise lowers transaction costs. Borrowers go directly to financial markets rather than individual savers, which is clearly more cost efficient.

A related function is the ***creation of liquidity***. The amount of time required to repay a loan may not be in line with the plans of an individual to recoup his savings. Pooling allows the financial system to lend to short- and long-term endeavours, allowing investors to earn higher returns than would otherwise be possible. Stock markets are particularly important in this regard, as equity constitutes a significant portion of firms' long-term capital.

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17 For a seminal exposition of Levine's hypothesis, see Robert King and Ross Levine, "Finance and Growth: Schumpeter Might be Right" (1993) 108 Q. J. of Econ. 717.

18 For a comprehensive survey of the empirical research of the causality relationship, see Paul Wachtel, "How much do we really know about growth and finance?" (First Quarter 2003) Federal Reserve Bank of Atlanta Economic Review 33.

19 Ross Levine "Financial Development and Economic Growth: Views and Agenda" (1997) 35 J. Econ. Lit. 688.

Resource allocation: Because of the cost of obtaining information, individual savers are not in a position to evaluate whether particular borrowers or projects are worthwhile. The institutions and professionals of the financial system develop expertise which enables them to better decide who receives loans.

Risk management: Investment is inherently risky owing to imperfect information and exogenous events. Theory demonstrates that portfolio diversification is the best means to minimize risk. Having pooled the savings of individuals, financial markets are able to diversify across a range of investments, thereby minimizing risk to return.

Managerial monitoring: Related to the function of resource allocation, the use of credit must be monitored over the life of an investment. Financial markets, including institutions, capital markets and public institutions and policies, all serve to monitor the actions of managers and entrepreneurs. Professionals in the financial system have expertise that may allow them to better evaluate information about operations and projects. The degree of transparency of such information is integral to the functioning of the economy.

Trade facilitation: Just as the creation of money as a unit of exchange greatly simplified trade compared to the barter system, so too do financial markets facilitate trade. Financial markets support individuals as they "buy now and pay later", which adds tremendous efficiency to the economy.

Another channel that is sometimes included in this list is the sector's own contribution to technological advancement. The financial services industry is among the largest purchasers of information technology software and hardware in the economy, which helps drive the process of innovation and the dissemination of technology throughout the other sectors of the economy. Thus, the activity of the financial sector itself helps to drive productivity growth for the economy as a whole.

Levine argues that each of the five main channels contributes to both capital accumulation and the process of technological innovation. These in turn feed directly to economic growth as explained by the traditional Solow growth model. By using carefully designed methods, King and Levine were able to demonstrate the statistical significance of the causal relationship between finance and growth.[20] They found that the level of financial development in a group of countries in 1960 was shown to predict subsequent economic growth over the following 30 years.

However, establishing causality is tricky business. Sceptics have argued that the *expectation* of economic growth could contribute to the prior development of the financial sector in anticipation of the future needs of the economy. This could show up as a false causal relationship and explain the findings of King and Levine. Moreover, any empirical test of a proposed economic relationship potentially suffers from the omission of important factors that can skew the results. For example, an exogenous increase in

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20 *Supra* note 17.

the savings rate could account for both an increase in economic growth and financial development. Factors such as these must be controlled for in order to prevent a mis-measurement of the causality relationship.

Robert Lucas argued that financial factors and physical capital are less important for growth than human capital.[21] Paul Krugman notes that similar investment to GDP ratios in different countries or similar stocks of physical capital can exhibit wildly different growth patterns.[22] Again, the implication is that investment and physical capital are not as important as many might think.

What these observations highlight is the importance of *how* financial systems function in a particular country and the policy environment that governs their operation. A high level of savings and investment alone is no measure of success – a fact all too sharply demonstrated by the failure of the Soviet Union, which had robust savings and investment but allocated them to inefficient uses. A country's financial system plays a pivotal role in ensuring that savings are efficiently channelled into optimal investments. Countries that are successfully able to harness the productive capacity of savings and investment typical register high rates of growth and increasing standards of living.

Rajan and Zingales offer an informative contribution to the debate, bolstering the argument in favour of causality.[23] Their hypothesis is simple. If finance is said to increase growth, then financial development should have a greater impact on industries that rely on external finance than those that rely more on retained earnings to fund investment. Their findings showed that industries with a relatively high dependence on external finance grew faster in countries with higher levels of financial development.[24] Typically, this includes industries at the high technology frontier, reflecting their need for R&D funds. It also includes young firms that need finance from external sources to get off the ground.

This result has important implications for policy makers interested in strategically promoting the technology sector and new business formation.

These arguments support the overall importance of finance, but what are the particular features of a successful financial system? One body of literature focuses on the relative roles of financial intermediaries (banks) and capital markets in the financial

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21 Robert Lucas, "On the Mechanics of Economic Development" (1988) 22 J. of Monetary Econ. 3.

22 Paul Krugman, "International Finance and Economic Development" in *Finance and Development: Issues and Experience* (1993).

23 Raghuram Rajan and Luigi Zingales, "Financial Dependence and Growth" (1998) 88 American Econ. Rev. 559.

24 Data definitions are an important challenge in this body of literature. Financial development can be defined in different ways. Rajan and Zingales measure it as the size of a country's stock market plus the amount of bank credit (relative to GDP).

system. Other literature addresses the importance of government policy which defines the playing field for financial market participants. This latter issue is addressed in the next section.

Differences in national traditions with respect to the organization of financial markets have long attracted the interest of academics. Japan, Germany and continental Europe have traditionally relied more heavily on financial intermediaries, whereas the U.K., U.S., Canada and other Anglo-Saxon countries have relatively more developed private capital markets. These cross-country differences allow for interesting tests of which system works better over the long run.

In the 1980s, there was a sense that Japan's bank-based system was the ideal model to emulate and would soon overtake the rest of the industrial world. The subsequent woes of Japanese banks renewed the enthusiasm for the raw capitalist style of U.S. stock markets. However, the recent boom and bust episode in the U.S. market revealed risks and flaws in that system as well. The lesson may be that both market and bank-based systems have their own unique advantages and risks. The optimal financial system should incorporate elements of both.

A modern financial system requires both intermediaries and capital markets because each has comparative advantages that serve the needs of firms at different stages of maturity.[25] The comparative strength of banks is in their ability to collect and interpret information about investment opportunities and monitor projects. Individual savers have less capacity to do so without incurring substantial cost. Moreover, in markets characterized by open information, incentives for individuals to collect information may be lowered, since such information quickly becomes common knowledge in the market, negating any unique advantage.

Banks can develop a close working relationship with firms, enabling them to make prudent lending decisions on the basis of the expertise they accumulate. Banks are also better equipped to operate in less-than-ideal legal environments, since they have sufficient weight to make borrowers reveal necessary information and repay loans. Thus, intermediary-based systems are common in less developed countries characterized by small, unsophisticated individual investors and rudimentary legal systems.

The criticism of intermediaries is that they tend to favour low-risk projects, which may curtail technological progress and economic growth. Moreover, the power of banks may be sufficient to extract large "rents" from firms, which dampens the incentive to undertake projects. Indeed, some evidence shows that the cost of capital of firms with close intermediary ties is higher than that of other firms, which shows that banks take a large share of returns. There is also a risk that close relationships between banks and firm managers may result in collusion that is not in the interests of competition and individual savers (e.g. so-called "crony capitalism").

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[25] Veronika Dolar and Cesaire Meh, "Financial Structure and Economic Growth: A Non-Technical Survey" (September 2002) Bank of Canada Working Paper 2002-24.

Capital markets may have some advantage in dealing with uncertainty and new ideas. Because new technologies have no track record, by definition, their potential for success is subject to diverse opinion. Capital markets bring such diverse views together and may result in relatively more funding for risky endeavours compared to intermediary-based systems, where investment decisions are determined by a relatively small group. Capital markets may be better at diversifying risk by virtue of the wide range of instruments they make available to investors (e.g. hedge instruments, derivatives etc.). In countries dominated by intermediaries, the range of instruments is controlled and smaller. However, the liquidity of capital markets may lower the incentive of investors to monitor projects, since individual shareholders can readily bail out and have no tied interest to the life of a project.

Numerous studies have compared the performance of intermediary-based and market-based systems and find essentially no difference between them. Most conclude that it is the overall degree of financial development that is important for economic performance. These findings reinforce the functional view that it is the function of financial markets that matters. A modern economy relies on both types of finance. However, some studies do reveal important differences in the properties of intermediaries and capital markets that warrant further consideration.

Tadesse finds that countries with under-developed financial sectors fare better with intermediary-based systems, whereas more sophisticated economies do better with market-based systems.[26] Ergungor finds that market-based systems outperform in countries with flexible legal systems that can adapt to changing economic conditions.[27] This finding helps explain why countries with legal systems based on civil codes tend to favour intermediary systems, whereas countries with a common law tradition have greater reliance on capital markets. In general, civil law is less flexible than common law in dealing with disputes over contracts. Thus, in civil law environments, large, powerful banks are needed to manage and resolve market conflicts without recourse to the courts.[28]

Ergungor's findings partly explain why banks play a relatively larger role in the economies of continental Europe, where there is a civil law tradition. Of interest, these systems, as well as that of Japan, performed particularly well in the post-war period when the needs of re-building after war made the decisions of resource allocation relatively straight forward and easily managed by large banks. As greater uncertainty set in, countries with capital-market based systems generally performed better in identifying new opportunities and managing the associated risks.

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26 Soloman Tadesse, "Financial Architecture and Economic Performance: International Evidence", online at http://dmsweb.badm.sc.edu/tadesse/.

27 O. Emre Ergungor, "Financial System Structure and Economic Development: Structure Matters" (July 2003) Federal Reserve Bank of Cleveland Working Paper 0305.

28 These findings point to a potentially interesting area of research on the relative importance of intermediaries in Quebec (which has a civil code) and the rest of Canada.

Combining these conclusions suggests that capital markets will be increasingly important for a country like Canada. Canadian capital markets have grown markedly over the past decade. The stock of outstanding marketable securities increased by 115 per cent between 1990 and 2000.[29] Capital markets now account for 31 per cent of Canadian companies' short-term external financing needs and 88 per cent of long-term external financing.[30]

Technology-intensive firms and new, small firms that are often highly innovative typically rely on external sources of finance. Moreover, capital markets tend to be relatively more supportive of risky, new ideas compared to banks. If it is these sectors that public policy makers want to encourage in order to stimulate the process of technological advancement and create new areas of comparative advantage in a globalized world, then vibrant capital markets are essential.

4. Regulation, Efficient Financial Markets and Growth

The links between the financial system and economic growth underscore the importance of public policies to govern the financial sector and the importance of an economy's institutions. The financial sector is one of the most heavily regulated in the advanced economies. The purpose of this section is to examine the role of securities regulation in capital markets.

Why are regulatory institutions needed at all? Economic theory suggests that markets are best left to operate freely unless there are market failures that may be remedied by government intervention. Typical market failures are *asymmetric information,* whereby not all market participants have access to the same information about investment opportunities and performance, and *externalities*, whereby market participants do not fully factor in the broader social costs or benefits of their actions. Financial markets exhibit both of these market failures to some degree, warranting a fundamental role for government. In particular, "financial market confidence" can be considered as an externality, as it is a public good that would be under-supplied by the private market place if left to their own devices. Government regulation can contribute to confidence and systemic stability, which is of benefit to all citizens.

Another key role for government is the establishment of a sound and trusted legal system. An important body of research (Laporta et al, 2003) argues that national legal systems designed to support creditor rights (in particular, the rights of minority shareholders), sound governance and effective legal enforcement mechanisms are at

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29 The two main products traded in the securities industry are fixed-income securities (i.e. bonds and money market instruments) and equities. Fixed-income products are traded in dealer markets, whereas equities are traded on stock exchanges.

30 Department of Finance.

the core of effectively functioning financial markets.[31] Indeed, some interpret this view to mean that the legal system could entirely take the place of direct regulation of financial markets. However, the two work together as complements to ensure the efficient operation of financial markets. Without the rules developed by regulators, there would be little basis on which the legal system could ensure adequate enforcement.

Asymmetric information has two main consequences that impair the efficient operation of capital markets and give rise to the need for investor protection. *Adverse selection* occurs when one side of a trade has more information about the underlying quality of the traded good or service. The inability of the other participant to evaluate the quality of the good or service results in it being mis-priced and a suboptimal amount of trade.[32] For example, if a portfolio manager promotes quality investments and shady deals as equivalent products, investors may not be able to distinguish between the two categories and therefore under-price all investments as a way to insure against potential losses from bad deals. This results in a deadweight loss to society because too little investment will be undertaken in aggregate.

Moral hazard refers to the incentives to use asymmetric information in an opportunistic fashion. For example, portfolio managers may put their own interests ahead of the consumer, even to the point of committing fraud.[33]

Thus, securities regulation is designed with three main objectives - to protect investors, promote market efficiency, and bolster investor confidence. "Market efficiency" is defined as maximizing the accumulation of capital, while minimizing transaction costs, with optimal allocation to best uses.

Securities regulators pursue these objectives through three main functions. First, they impose disclosure obligations on particular transactions and on an ongoing basis. This is intended to ensure that all information relevant to a particular investment is available to all market participants (which reduces the adverse selection problem). Second, regulators license securities professionals – so-call "fit and proper tests" to establish standards, evaluate the credentials of the sellers of securities and monitor their activity.[34] Finally, regulators enforce anti-fraud provisions, which provides for civil and criminal sanctions. In Canada, securities regulation is undertaken by official regulatory bodies as well as a network of self-regulatory organizations that work together in a collaborative manner.

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31 Rafael La Porta, Florencia Lopez-de-Silanes and Andrei Shleifer, "What Works in Securities Laws?" (August 2003) NBER Working Paper no. w9882.

32 This principle was developed by George Akerlof in the early 1970s and is also known as "the market for lemons".

33 The opportunistic use of asymmetric information does not run in only one direction. For example, consumers of insurance products may misrepresent their knowledge about the risk of various outcomes to agents.

34 Franklin Allen and Richard Herring, "Banking Regulation versus Securities Market Regulation" (July 2003) Financial Institutions Centre, Wharton School.

As well, insurance mechanisms can help mitigate investor losses. Public insurance schemes cover a portion of bank deposits, but are less common in the securities area, outside of the coverage against losses of some pension plans.[35] One reason for this is the difficulty for an insurer to distinguish whether losses from securities trades are the result of misleading advice or simply a bad outcome.

Finally, investors are protected by the reserve, liquidity and capital requirements that apply to financial institutions, although these are more prevalent in the banking sector than the securities industry. The claims on securities firms are contingent on outcomes, which limits their losses, whereas bank liabilities are non-contingent, which puts them at greater risk of insolvency. Moreover, the assets of securities firms are marked-to-market daily. Nevertheless, to the extent that reserve requirements exist, they help protect investors by ensuring the solvency of institutions.

The increasing depth and sophistication of capital markets creates new threats to investor protection and challenges for securities regulators. Moreover, the recent international focus on combating terrorist financing adds another degree of complexity and urgency to reporting requirements. In this regard, regulators in all financial sectors have been called upon to work with their international counterparts to stay one step ahead of abusers of the system. The growth of the internet provides new channels for nefarious investment dealers to unsophisticated investors. The internet and e-commerce are reducing the significance of national and regional boundaries, creating new challenges for regulators confined to geographic jurisdictions.

More and more consumers have a direct stake in the performance of equity markets, both through their direct stock holding and indirect holdings through mutual funds and pension plans. It is estimated that 46 per cent of Canadians directly own equity securities, double the proportion of the 1990s.[36] As well, the enormous growth in mutual funds over the past decade has transformed a large number of unsophisticated investors into indirect stock market participants. Bank of Canada data show that 19 per cent of Canadian household assets are in the form of direct and indirect holdings of equity. Regulators have been challenged to strengthen their investor protection roles in response to these developments.

The main challenge for securities regulators is to balance market efficiency with the need for regulation. The competitive pressures of global integration complicate this balancing act. Overly intrusive government policies can add to the cost of doing business and drive international investment capital to other destinations. The high degree of capital fungibility implies a potentially significant and rapid reaction to even small costs and frictions caused by government policy.

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35 In Canada, the Canadian Investor Protection Fund (CIPF) protects investors in the event of the insolvency of a firm belonging to one of the national self-regulatory organizations.

36 Harold MacKay, Letter to Minister of Finance (November 15, 2002) online at http://www.fin.gc.ca/.

At the same time, regulations that are too lax increase the potential for abuse and dishonest practices, which lowers overall confidence in the system. This too may drive capital to other, safer market environments. Thus, an essential objective of regulation is to protect against risks that threaten investor confidence in the system. This function recognizes the social benefits of sound and efficient capital markets that amplify the private returns earned by individual market participants. That is, the contribution of capital markets to economic growth is a social good that benefits not only market participants themselves, but all of society.

The investor protection function can come into conflict with the goal of market efficiency to the extent that competitive forces are dampened. If investor protection rules are too burdensome, they will stifle financial activity and risk taking. Regulatory burdens impose costs that raise the cost of capital and lower investment. Regulation must maximize investor protection and investor confidence, while at the same time minimizing harmful effects on market efficiency.

Optimally designed regulations contribute to market efficiency. For example, a license from the regulator serves as a stamp of approval that affords credibility to new dealers, avoiding the need for the entrant to build up a reputation over time. In this way, the cost to entry is lowered and efficiency improved by facilitating the signalling mechanism between dealers and investors.

The principles of competition suggest that it is optimal to permit maximum ease of entry into the market. However, securities regulators place tight controls on who may sell securities and on the disclosure requirements of projects. In this way, regulatory requirements designed to protect investors introduce frictions to trading that can reduce market efficiency. Thus, it is essential that regulatory requirements are shown to be in the interests of investors and not unduly bureaucratic. For example, one of the principles of fair and transparent regulation stated by the OECD is that regulations and regulators should not discriminate among licensed market participants on the basis of nationality or jurisdiction.[37]

A Glance Back and a Look Forward…

Securities regulation has a long history, dating back to the British Bubble Act of 1720, which was passed to prohibit the deliberate manipulation of stock prices. Over time, a tradition of regulation was developed through legislation and practice that established the principle of disclosure through the registration of prospectuses.

The core framework of U.S. securities regulation emerged over the first half of the 20th century. Beginning with "blue sky" state laws designed to promote investor protection, the framework was enhanced with a national dimension with the passage of a series of laws through the 1930s and 1940s. The most important outcome of this wave

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37 OECD-APEC Co-operative Initiative on Regulatory Reform, "Promoting Fair and Transparent Regulation in Securities Markets" (2001).

of federal legislation was the establishment of the Securities and Exchange Commission (SEC). The SEC is the primary overseer and regulator of the U.S. securities markets, but works closely with many other institutions, including Congress, other federal departments and agencies, self-regulatory organizations (e.g. the stock exchanges), state securities regulators, and various private sector organizations.[38] The lead role of SEC was strengthened most recently in 1996 with the passage of the National Securities Markets Improvement Act.

Securities Commissions were established a little later in Canada at the provincial level.[39] Today, each of the 13 provinces and territories has its own securities commission, which exchange information and ideas through the informal network of the Canadian Securities Administrators (CSA). The provinces originally assumed responsibility for securities regulation in accordance with their constitutional jurisdiction over property and civil rights. At that time, a much larger proportion of securities activity was intra-provincial than is the case today. For example, a decade ago, there were five regional stock exchanges in Canada – Toronto, Montreal, Winnipeg, Calgary, and Vancouver. Since then stock exchange consolidation has occurred with the TSX and TSX Venture exchanges now serving the national market.[40]

The increasingly national dimension of the securities industry has given rise to periodic initiatives to reform the structure of securities regulation in Canada to introduce a more national approach. However, past efforts to create a federal presence in the field securities regulation did not come to fruition.[41] As a result, Canada continues to be the only G-7 country without a national securities regulator .

Provincial authorities have recognized the need for enhanced co-operation and harmonization, given the national and international dimensions of capital markets. Together and through the CSA, they have implemented a number of initiatives designed to increase harmonization and market efficiency. The CSA is currently developing uniform securities legislation with the objective of complete uniformity across provincial jurisdictions. The Provincial Ministers with responsibility for securities regulation are examining the feasibility of a passport model to facilitate inter-provincial securities

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38 For a detailed description of securities regulation in the US, see Joel Seligman, "The United States Federal-State Model of Securities Regulation" (WPC Research Study, 2003).

39 For example, the Ontario Securities Commission was established in 1945 and the Commission des valeurs mobilieres du Quebec was established in 1955.

40 The Bourse de Montreal specializes in financial derivatives. The Winnipeg Commodity Exchange deals in select agricultural futures.

41 Prior reform initiatives include the Porter Report (1964), CANSEC proposal (1967), the Proposal for a Securities Market Law for Canada study (1979), and the 1994 Memorandum of Understanding and its revival in 1996. For a description of these initiatives, see A. Douglas Harris, "A Symposium on Canadian Securities Regulation: Harmonization or Nationalization?" (2002).

activity. The federal Wise Persons' Committee has been mandated to consider these initiatives and evaluate whether a passport system of this nature or a single national regulator represents the most logical next step to improve Canada's system of securities regulation.

The interconnectedness of global capital markets creates significant pressure to adopt common international rules. National securities regulators must balance this pressure to harmonize domestic rules to international standards with the need to tailor policies to domestic circumstances where warranted. Canada's proximity to the dominant U.S. market creates significant incentive to stay closely in line with U.S. regulatory practice.

Another important international trend is regulatory consolidation. Since the late 1980s, the lines separating the traditional four pillars of the financial sector (banks, trusts, insurance companies, and securities dealers) have steadily blurred in Canada and elsewhere. Increasingly, organizations and financial products cut across traditional categories. Some countries have responded by consolidating their approach to financial regulation to varying extents, bringing all financial regulatory bodies together within one organization. The U.K.'s Financial Services Authority (FSA) is a leading example. Australia and other countries have also consolidated financial sector regulation at different levels of government.[42]

Internationally, the parallel is the Financial Stability Forum (FSF), established by the G-7 in 1999 to promote international financial stability through information exchange and international co-operation in financial supervision and surveillance. The Forum brings together on a regular basis national authorities responsible for financial stability in significant international financial centres, international financial institutions, sector-specific international groupings of regulators and supervisors, and committees of central bank experts. Canada is represented at the Forum by the Department of Finance, the Bank of Canada, and the Office of the Superintendent of Financial Institutions (OSFI). The broad representation of the FSF reflects the growing interrelationship across traditional segments of the financial sector.

Consolidation of financial market regulation has occurred in Canada in Saskatchewan and Quebec (where the move to consolidation of securities, insurance, and pension regulators is underway). The Joint Forum of Financial Market Regulators was established in 1999 as an informal network of Canadian securities, insurance and pension regulators. To the extent that Canada as a whole decides to move toward regulatory consolidation in the future, consolidation of provincial securities regulators may be a necessary pre-condition.

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42 For more information on the Australia case, see Ralph Simmonds and Ray Da Silva Rosa, "The Impact of Federalizing Securities Regulation in Australia: A View from the Periphery" (WPC Research Study, 2003).

The merits of regulatory consolidation remain subject to debate.[43] Regulatory consolidation may be justified on the basis of the shared issues of solvency and consumer protection across financial products and services. Second, a consolidated regulator may be in a better position to limit risk transference among related affiliates. At the same time, full consolidation may be premature where some segmentation remains within the financial industry. Moreover, authorities need to consider whether consolidation should absorb the traditional regulatory function of the central bank, since the central bank typically requires unique market information that may warrant a distinct role.[44] Overall, there is a healthy ongoing debate over the relative merits of regulatory consolidation.

In an environment where capital markets are steadily undergoing change, it is essential that regulators are flexible and responsive in order to achieve their objectives. Above all, they need to take account of international developments and capitalize on opportunities to define standards of excellence. In a global marketplace, regulators must be constantly vigilant to new threats to investors, while ensuring that protection does not stifle capital market activity. International competition for capital adds to the importance that regulators appropriately balance investor protection and market efficiency.

5. Conclusion

This paper has brought together three key features of the modern economy. First, financial markets increasingly operate in a global environment that promises to continue to expand and increase in complexity. Second, financial developments and the institutions of the financial system are important for productivity and long-term economic growth. Third, regulation is an essential ingredient of sound and efficient capital markets and sustained investor confidence.

Global integration offers tremendous growth potential to those who can harness its benefits while protecting against its adverse consequences. More than ever, capital is highly mobile, flowing to wherever it can earn the highest risk-adjusted return. Intensifying competition among financial service providers has created inexorable pressures to reduce costs and differentiate products. In this environment, government policy makers have a clear challenge to attract domestic and foreign capital and bolster confidence in the domestic financial system in a way that does not impose undue costs to market participants. Regulatory policy must walk a careful line between protecting individual investors and allowing markets to operate as unimpeded with no more impediments than are required to maintain safety and soundness.

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43 Robert Litan and Charles Calomiris, "Financial Regulation in a Global Marketplace" (2000) Brookings-Wharton Papers on Financial Services.

44 This would not be an issue in Canada. The Bank of Canada supervises the systemic operation of the financial system but does not regulate directly. This role would not change as a result of regulatory consolidation.

Canada's history of openness to the world economy and sound economic and financial policies has been the key to achieving our status as one of the world's largest and most robust economies. Information and ingenuity will characterize the 21st century economy. Technology has transformed production methods in all sectors, especially the financial sector. Just as capital was needed to build the industry of the past, it will be fundamental for the success of the industry of tomorrow.

The modern financial sector has grown substantially in the past decade alone and is characterized by the use of advanced technology and complex systems of portfolio and risk management. In this environment, if Canadian capital markets are to be chosen by international and domestic investors alike, the policy environment that helps define them must be both efficient and effective and it must be perceived to be so. Policy makers cannot be content with the merely adequate if their objective is to achieve high rates of growth spurred by robust investment. To stand out in a crowded field, Canada must excel on all the criteria that figure in investors' portfolio decisions.

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The United States Federal-State Model of Securities Regulation

Research Study Prepared for the
Wise Persons' Committee

Joel Seligman

September 4, 2003

The United States Federal-State Model of Securities Regulation

Biography

Joel Seligman

Joel Seligman is the author or co-author of 20 books and over 35 articles on legal issues related to securities and corporations, including the 11-volume treatise co-authored with the late Louis Loss, *Securities Regulation*. He is the co-author of *Fundamentals of Securities Regulation* and the casebook, *Securities Regulation* which he co-wrote with John Coffee. His book, *The Transformation of Wall Street: A History of the Securities and Exchange Commission and Modern Corporate Finance*, is widely regarded as the leading history of the Commission.

At the University of Arizona College of Law, Seligman was named dean and the Samuel M. Fegtly Professor of Law in 1995. He previously served on the law faculty of the University of Michigan (1986-1995), George Washington University (1983-1986), and Northeastern University (1977-1983). He has served on the Arizona State Bar Board of Governors (1995-1999) and as a consultant to the Federal Trade Commission (1979-1982), U.S. Department of Transportation (1983), and Office of Technology Assessment (1988-1989).

Since beginning as dean at Washington University School of Law in 1999, Seligman served as Reporter for the National Conference of Commissioners on Uniform State Law which adopted a new Uniform Securities Act in July 2002; in 2000-2001 was Chair of the Securities and Exchange Commission Advisory Committee on Market Information; and has served as a member of the American Institute of Certified Public Accountants Professional Ethics Executive Committee.

Seligman received his bachelor's degree magna cum laude from the University of California at Los Angeles in 1971 and his law degree cum laude from Harvard University School of Law in 1974.

The United States Federal-State Model of Securities Regulation

Executive Summary

Constitutional Authority

Under the United States Constitution, the federal government may regulate all or virtually all aspects of securities trading involving interstate commerce given the authorization of the Constitution's Commerce Clause "to regulate commerce . . . among the several states." A state generally may regulate all aspects of securities trading within its jurisdiction.

Current Structure of Federal and State Regulation

Between 1933 and 1940 the United States Congress superimposed six federal statutes to function concurrently with existing state securities laws. Four of these laws form the core of the United States federal securities law today. The Securities Act of 1933 is largely concerned with the initial distribution of securities rather than with their subsequent trading. The Securities Exchange Act of 1934 addresses the post-distribution period, that is, subsequent trading. The Investment Company Act of 1940 is a regulatory measure for mutual funds and other investment companies that engage primarily in the business of investing and reinvesting in securities of other companies. The Investment Advisers Act requires registration with the SEC of persons engaged for compensation in the business of rendering advice or issuing analyses or reports concerning securities. It also outlaws fraudulent or deceptive practices on the part of registered advisers and, in substance, prevents assignment of any advisory contract without the client's consent.

After Congress enacted these federal securities laws, there were three generally recognized reasons that state statutes were retained. First, political sentiment as articulated by state and local officials to sympathetic federal legislators favored a state role. Second, the state statutes over time were generally rewritten to reduce the compliance burdens at the state level when a securities issuance is registered at the federal level. Third, the states in aggregate have performed a significant enforcement role particularly with respect to fraud in local securities offerings.

Nonetheless by the 1980s there were fundamental tensions in United States federal-state securities regulation.

While the mandatory disclosure system of the federal securities laws only requires full and complete disclosure of material information, virtually all state jurisdictions specify additional standards for the denial, suspension, or revocation of securities registration. Through 1995, 18 states retained traditional "merit regulation" standards by which these states could deny registration to a security on such grounds as its plan of business was "unfair, inequitable or unjust." After the securities industry and securities regulators failed to achieve a consensus on merit regulation in the little enacted Revised Uniform Securities Act of 1985, Congress restructured federal-state securities regulation through the National Securities Markets Improvement Act of 1996 ("NSMIA").

The 1985 breakdown was a significant exception to the generally successful United States experience with Uniform State securities laws, measured in terms of reducing the variations in compliance with state laws. Uniform state securities laws were developed in order to reduce variations in state securities laws, and not as an alternative to concurrent federal-state regulation. These laws have benefits for domestic market participants in terms of reducing the costs and the complexity of compliance in inter-jurisdictional transactions. However, a regulatory structure based solely on uniform legislation without federal regulation would not, in my view, represent the best model for the purposes of facilitating international investment, since foreign issuers and investors would be required to deal with multiple regulators and inconsistent administration of that uniform legislation without federal law being available to solely or largely address specified international transactions.

NSMIA was most significant for its partial preemption of state law in the securities offering and shareholder report areas for "covered" securities, which include securities listed or authorized for listing on the NYSE, Amex and the Nasdaq National Market System list. The list of covered securities includes the vast preponderance of major United States issuers.

States retain the authority to investigate and bring enforcement actions with respect to fraud or deceit, or unlawful conduct by a broker or dealer, in connection with securities or securities transactions. NSMIA preempted state law from establishing additional capital, custody, margin and other requirements for brokers, dealers, municipal securities dealers, government securities brokers, or government securities dealers. Subject to this limit, the states, however, are permitted to register broker-dealers and bring enforcement actions.

As a general matter, NSMIA did not cause states to reduce the size of their securities regulatory bodies, despite the increased scope of federal preemption that NSMIA introduced. The states generally shifted resources to increased enforcement that were formerly devoted to preempted regulatory activities.

Practical Implications of the Current Structure

After NSMIA the federal securities laws employ three separate methods to coordinate federal-state securities laws:

1. Specified aspects of the registration and periodic reporting of covered securities, broker-dealer regulation, and investment adviser registration and regulation are *preempted* in full or in part by NSMIA.

2. Enforcement remains subject to *concurrent federal and state regulation* under express provisions preserving the jurisdiction of state securities commissions.

3. The Securities Act of 1933 authorizes the SEC to cooperate, coordinate, and share information with the North American Securities Administrators Association (NASAA) that operates in both Canada and the United States.

These federal-state securities coordination methods function differently with respect to policy development, enforcement and regulatory flexibility.

Policy Development

With respect to policy development, the Securities Act stresses a federal policy that emphasizes "maximum uniformity in Federal and State regulatory standards." In recent years, cooperation has been a mantra of both United States federal-state securities policy development and efforts by the states to harmonize state policies. Nevertheless, the degree of federal-state cooperation in securities regulation should not be overstated. There are important policy differences on occasion between the SEC and the NASAA or among the states themselves. To put this in different terms, the SEC has not acted as if constrained by the statutory emphasis on cooperation when responding to emerging market needs when they were time sensitive.

Under the United States Constitution Supremacy Clause when there is a conflict between the SEC and the states, the SEC as a legal matter will prevail when there is a federal securities statute or rule and simultaneous compliance with a state law "is a physical impossibility"; the state law "stands as an obstacle to the accomplishments and execution of the full purposes and objectives of Congress"; or the state law "frustrates the purposes of the federal law." As a practical matter, the SEC has been constrained in relying on the Supremacy Clause, particularly by its need to work with the states in enforcement matters where the SEC has often been understaffed.

For the most part the SEC has largely deferred to the states on intrastate and local policy issues.

Enforcement

Enforcement remains the area of federal and state securities law that continues the most complete degree of concurrent regulation. While the United States Congress in the Private Securities Litigation Reform Act of 1995 and the Securities Litigation Uniform Standards Act of 1998 has limited private securities class actions at both the federal and state level, NSMIA expressly preserved state securities commission authority to investigate and bring enforcement actions with respect to fraud or deceit or unlawful conduct in connection with securities transactions.

There is an implicit nonstatutory assumption that the states will largely enforce intrastate and smaller claims and the SEC will primarily enforce interstate and larger claims. States bring a larger volume of enforcement actions than does the SEC, but these actions tend to be smaller (in terms of the dollar amounts at issue), involve individual defendants, and often relate to failures to register securities, individual broker-dealers, or individual investment advisers. SEC enforcement actions tend to be larger (in terms of the dollar amounts at issue), involve multiple defendants, and relate to a wider range of claims. Occasionally there has been frustration with this nonstatutory assumption either because particular states have been inadequately funded to perform a meaningful enforcement role or when the SEC has expressed concerns about state security commissions or Attorneys General addressing major *interstate* claims.

As a general matter the two most serious ongoing enforcement issues have been inadequate enforcement budgets in many states and periodically at the SEC. When there are significant increases in fraud, as there appeared to be in late 1990s, many states and the SEC can be overwhelmed. This can lead to inconsistent policy with respect to interstate cases.

At the same time, there are important virtues of concurrent enforcement. SEC Chair Arthur Levitt was criticized for not adequately investigating broker-dealer research analysts during the late 1990s. Precisely because the states also had investigatory and enforcement powers, one state was able to take up the slack and initiate what became a $1.4 billion settlement with ten leading broker-dealer firms. Ultimately the SEC worked smoothly with the NASAA, NASD, and the State of New York on the Global Research Analyst Settlement.

Regulatory Flexibility

At a statutory level there is a sharp distinction between topic areas where federal law preempts state law (such as merit regulation standards applied to covered securities) and concurrent regulation where state rulemaking authority is largely unfettered. In practice the distinction is somewhat less sharp.

When states are not subject to NSMIA's preemptive provisions, the states have often taken, as an SEC report explained, "significant actions to enforce uniformity in regulating offerings of securities that are both 'covered' and 'not covered.'" These include coordinated review of filings, a uniform registration statement for offerings that are exempt at the federal level, and statements of policy on a number of review issues that enhance uniformity of review in the states.

Conclusion

While the United States federal-state system of securities regulation may appear reticulate, if not Byzantine, a core reality is that it generally has worked well. Both the SEC and the states perceive advantages to having more, rather than fewer, regulators involved, particularly to review filings, conduct examinations, and bring enforcement actions.

Given the institutional realities, both the SEC and NASAA have emphasized consultation, whether through periodic conferences, or NASAA comments on SEC rule and form proposals, or meetings or telephone calls on specific topics such as enforcement cases. It is the informal shared values and coordination that is pivotal to making the United States system work as well as it does.

It is worth emphasizing that the United States federal-state securities regulation system preserves a great deal of flexibility for each state to address local concerns. Even after NSMIA, it preserves state autonomy with respect to intrastate or local securities offerings, broker-dealers, and investment advisers, but establishes federal standards for covered securities, broker-dealer firms registered under the Securities Exchange Act, and investment advisers above a specified assets under management threshold. State securities fraud enforcement is not preempted.

To be sure there are costs to the concurrent system of regulation. But, on balance, even with these costs, the United States federal-state model of securities regulation has generally been perceived to work well.

If presented with the opportunity to design a regulatory structure for the United States on a clean slate, I would retain concurrent federal-state jurisdiction. The creation of the SEC in 1934 was a response to the shortcomings of state-only regulation with respect to enforcement of interstate claims, coordination among state regulators, inadequate budgets for state regulators, and what has been termed the resulting "balkanization" of state securities regulation. The state role in United States securities regulation exists today not solely because of path dependence (i.e., the historical fact of state securities regulation), but also because of the demonstrated benefits of state regulation, particularly the importance of the state role in intrastate enforcement.

Regulation by the SEC alone could lead to important gaps in the regulator's ability to enforce securities laws and a corresponding adverse impact on investor confidence. As the SEC's budget and resources have fluctuated in the past, the "fraud waves" that have occurred might have been even worse had there been no state enforcement resources to supplement those of the SEC. In designing a new concurrent structure, I would focus on identifying those matters that most appropriately should be regulated at the state and federal levels, particularly addressing the significance of local issuances and fraud on the one hand and national or international offerings and broker-dealer firms on the other.

The United States Federal-State Model of Securities Regulation

Under the United States Constitution, the federal government may regulate all or virtually all aspects of securities trading involving interstate commerce given the authorization of the Constitution's Commerce Clause (Art. I §8 (3)) "to regulate commerce . . . among the several states." A state generally may regulate all aspects of securities trading within its jurisdiction.

1. Current Structure of Federal And State Securities Regulation in the United States

State securities regulation in the United States effectively began in Kansas in 1911 with a comprehensive system for registration of securities and securities salespersons.[1] The Kansas Act popularized "merit regulation" under which a state securities administrator could deny a permit to sell securities in a state if an issuer's articles of incorporation, bylaws, plan of business or proposed contracts "contain any provision that is unfair, unjust, inequitable or oppressive to any class of contributors . . ."[2] Kansas also initiated the term "blue sky law" after the assertion of a state legislator that the Kansas Act was aimed at promoters who "would sell building lots in the blue sky in fee simple."[3]

In the 1917 *Blue Sky Cases* the United States Supreme Court upheld the constitutionality of the Michigan, Ohio, and South Dakota securities statutes.[4] By 1933, when the first United States federal legislation of general applicability was adopted, blue sky laws had been enacted in 47 of the then 48 states in the United States.[5]

In essence state securities statutes then and now had three primary functions:

1. the registration of securities;
2. the registration of broker-dealers and their agents and more recently of investment advisers and investment adviser representatives; and
3. the enforcement of fraud and other remedies.

After the United States stock market crash of 1929-1932, the state blue sky statutes, standing alone, were generally recognized to be inadequate. They were not effective in protecting citizens in one state from sales efforts originating in a second state;[6] inadequately funded by most states to provide for effective enforcement of fraud provisions;[7] and riddled with exceptions and exemptions.[8]

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1 Kan. L. 1911 Ch. 133.

2 *Ibid* §5. See generally 1 Louis Loss & Joel Seligman, *Securities Regulation*, 3d ed. (1998) at 36-40.

3 Mulvey, "Blue Sky Law" (1916) 36 Can. L. Times 27.

4 *Hall v. Geiger-Jones Co.*, 242 U.S. 539 (1917); *Caldwell v. Sioux Falls Stock Yards Co.*, 242 U.S. 559 (1917); *Merrick v. N.W. Halsey & Co.*, 242 U.S. 568 (1917).

5 Loss & Seligman, *supra* note 2 at 34-35, 40.

6 *Ibid* at 146-147.

7 *Ibid* at 147-150.

8 *Ibid* at 150.

Between 1933 and 1940 the United States Congress superimposed six federal statutes to function concurrently with state securities laws. Four of these 1930s laws form the core of the United States federal securities law today.

The Securities Act of 1933 is largely concerned with the initial distribution of securities rather than with their subsequent trading. Securities that are offered to the public through the mails or channels of interstate commerce must be registered with the SEC by the issuer. The registration statement must contain specified information about the security, the issuer, and the underwriters. The Commission has no authority to approve any security or to pass on its merits. Its sole function is to ensure that the registration statement is accurate and complete. A prospectus containing the basic information in the registration statement must be given to the buyer. Civil and criminal liabilities are imposed for material misstatements or omissions in the registration statement or prospectus. Certain types of securities and transactions are exempted from the registration and prospectus requirements but not from the antifraud provision.

The Securities Exchange Act of 1934, in contrast, addresses the post-distribution period, that is, subsequent trading. The 1934 Act, as initially enacted, had four basic purposes: to extend the mandatory disclosure system of the 1933 Act to issuer periodic reports; to amplify the remedies against fraud and manipulation; to regulate stock markets; and to control the credit available for securities purchases.

All stock exchanges must register unless exempted by the SEC, which has supervisory functions with respect to the rules and authority of the exchanges to suspend or expel their members who violate the Act. No security may be listed on an exchange unless its issuer files an application for registration with both the exchange and the SEC containing much the same information as is required for new issues by the 1933 Act. The information must be kept current by the filing of annual and other reports with the exchange and the SEC. The solicitation of proxies for listed and registered securities is subject to SEC control, and there are provisions governing the trading in such securities by the issuer's officers, directors, and principal stockholders.

Under the Securities Acts Amendments of 1964, the registration, reporting, proxy, and insider trading provisions were extended to any company with more than $1 million of gross assets (raised to $10 million by exemptive rule) and a class of equity security held by at least 500 persons.

There is also a provision, under a 1938 amendment of the Act, for the registration with the SEC of "national securities associations" of over-the-counter brokers and dealers for the purpose of regulating their business practices under the general supervision of the Commission. There is one such association, the National Association of Securities Dealers, Inc. (NASD).

In 1968, Congress added regulation of tender offers to the statutory scheme. The 1968 tender offer provisions, popularly known as the "Williams Act" after its Senate sponsor, were further amended in 1970.

In 1975, the 1934 Act was virtually doubled in size by broadening the market regulation provisions, with a direction to the Commission to facilitate the establishment of a national market system, and inserting the Commission for the first time into the clearance and settlement processes as well as regulation of the markets in municipal securities.

A major theme of the 1934 Act is self-regulation under the general aegis of the SEC. There are now five types of "self-regulatory organizations": the national securities exchanges; the NASD; since 1975, registered clearing agencies; also since 1975, the Municipal Securities Rulemaking Board; and since the Sarbanes-Oxley Act of 2002, the Public Company Accounting Oversight Board.

The Investment Company Act of 1940 is a regulatory measure for mutual funds and other investment companies that engage primarily in the business of investing and reinvesting in securities of other companies.

The Investment Advisers Act was passed in 1940 along with the Investment Company Act. It requires registration with the SEC of persons engaged for compensation in the business of rendering advice or issuing analyses or reports concerning securities. It also outlaws fraudulent or deceptive practices on the part of registered advisers and, in substance, prevents assignment of any advisory contract without the client's consent.

After Congress enacted these federal securities laws, there were three generally recognized reasons that state blue sky statutes were retained.

First, political sentiment as articulated by state and local officials to sympathetic federal legislators favored a state role. Members of Congress have often expressed awareness that the states receive budget support from fees paid for securities regulation. The SEC legislation specifically preserved the blue sky laws. Far from preempting a field when interstate commerce is involved, Congress affirmatively yielded to local regulation by inserting a number of intrastate exemptions even when the mails or facilities of interstate commerce are used[9] and more broadly adopted provisions generally preserving the jurisdiction of the state securities commissions.[10]

Second, the state statutes over time were generally rewritten to reduce the compliance burdens at the state level when a securities issuance is registered at the federal level. Today, over 40 state jurisdictions authorize securities registration by coordination.[11] This means that individual states unilaterally agree to reduce their securities registration requirements when securities issuers have filed a registration statement employing the Securities Act of 1933. In essence, the coordination procedure requires filing at the state level of copies of the registration statement filed with the SEC. There are a few additional required conditions such as an undertaking to forward all amendments to the federal registration statement. At the state level, there are few resources required to ensure compliance with this procedure since confirmation of federal filing can be done electronically today, if and when confirmation is deemed necessary. The registration statement automatically becomes effective at the state level at the moment the federal registration statement becomes effective.

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9 Sec. Act §3(a)(11).

10 See generally Loss & Seligman, *supra* note 2 at 275-281.

11 *Ibid* at 108-110.

Third, the states in aggregate have performed a significant enforcement role particularly with respect to fraud in local securities offerings.[12]

Nonetheless by the 1980s there were two fundamental tensions in United States federal-state securities regulation.

While the mandatory disclosure system of the federal securities laws only requires full and complete disclosure of material information, virtually all state jurisdictions specify additional standards for the denial, suspension, or revocation of securities registration. Through 1995, 18 states retained traditional "merit regulation" standards by which these states could deny registration to a security on such grounds as its plan of business was "unfair, inequitable or unjust."[13] A significant number of states employed a modified form of merit regulation, adopting the language of the 1956 Uniform Securities Act §306(a)(2)(F), which permits "merit" regulation only when "the offering has been or would be made with unreasonable amounts of underwriters' and sellers' discounts, commissions, or other compensation, or promoters' profits or participation, or unreasonable amounts or kinds of options." By the 1980s the wisdom of merit regulation was the leading policy debate concerning United States state securities regulation.[14]

Even if one assumes that the case for merit regulation could be persuasively articulated in a national context, this debate took on a different character when state law merit standards were applied to domestic or foreign issuers that could sell securities abroad. If enforcement of merit standards tended to encourage the distribution of securities issuances solely abroad, merit review was difficult to rationalize as providing advantages to either United States issuers or investors.

To some extent, many states reduced the conflict between their merit standards and actual or potential international offerings by adopting a "marketplace exemption" from merit review for securities listed on the New York and American stock exchanges.[15] Some states also exempt securities traded in the alternative over-the-counter market in the computerized Nasdaq National Market System list.[16]

Nonetheless, after the securities industry and securities regulators failed to achieve a consensus on merit regulation in the little enacted Revised Uniform Securities Act of 1985,[17] Congress restructured federal-state securities regulation through the National Securities Markets

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12 See generally Joel Seligman, "The Obsolescence of Wall Street: A Contextual Approach to the Evolving Structure of Federal Securities Regulation" (1995) 93 Mich. L. Rev. 649 at 673-682.

13 *Ibid* at 678.

14 There were by then two patterns of merit regulation. First, generic rules aimed at regulating such practices as "cheap stock" or excessive options. Second, specific guidelines regulating industries such as real estate or oil and gas. For a 1986 review of the debate concerning merit regulation, see ABA Ad Hoc Subcomm. on Merit Reg., "Report on State Merit Regulation of Securities Offerings" (1986) 41 Bus. Law 785.

15 Seligman, *supra* note 12, at 681.

16 *Ibid.*

17 See Hensley, "The Development of a Revised Uniform Securities Act" (1985) 40 Bus. Law. 721; Sargent, "Some Thoughts on the Revised Uniform Securities Act" (1986) 14 Sec. Reg. L.J. 62; Hensley, "The Revised Uniform Securities Act – The Debate Continues" (1988) 43 Bus. Law. 765; Sargent, "RUSA Revisited" (1989) 17 Sec. Reg. L.J. 79.

Improvement Act of 1996 ("NSMIA"). The 1985 breakdown was a significant exception to the generally successful United States experience with Uniform State securities laws. Success here is measured in terms of reducing the variations in compliance with state laws. Greater uniformity was particularly a benefit when an issuer contemplated filing a new issue in all 50 states. In the United States over 35 of the 50 states adopted the 1956 Uniform Securities Act and simplified compliance with state law registration and regulation requirements. Several large states including New York, California, Illinois, Texas and Florida, however, did not adopt the 1956 Act, encouraging the 1985 revision effort. This effort largely failed because of unbridgeable differences between the securities industry and regulators primarily on merit regulation and exemptions from the Act. NSMIA was the only federal response to the securities industry-securities regulator tension and it came only after the 1994 Congressional elections shifted control of both houses of our Congress from the Democratic to the Republican party.

Uniform state securities laws were developed in order to reduce variations in state securities laws, and not as an alternative to concurrent federal-state regulation. These laws have benefits for domestic market participants in terms of reducing the costs and the complexity of compliance in inter-jurisdictional transactions. However, a regulatory structure based solely on uniform legislation without federal regulation would not, in my view, represent the best model for the purposes of facilitating international investment, since foreign issuers and investors would be required to deal with multiple regulators and inconsistent administration of that uniform legislation without federal law being available to solely or largely address specified international transactions.

NSMIA was most significant for its partial preemption of state law in the securities offering and shareholder report areas. Under amended §18(a) of the Securities Act of 1933, no state statute, rule, order, or other administrative action may apply to

> (1) The registration of a "covered" security or a security that will be a covered security upon completion of the transaction;
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> (2)(A) Any offering document prepared by or on behalf of the issuer of a covered security;
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> (2)(B) Any proxy statement, report to shareholders, or other disclosure document relating to a covered security or its issuer that is required to be filed with the SEC or any national securities organization registered under §15A of the Security Exchange Act; or
>
> (3) Any state regulation based on the merits of a covered security or a security that will be a covered security upon completion of the transaction.

Section 18(b) of the Securities Act of 1933 limits the scope of §18(a) to four types of "covered securities":

> (1) Securities listed or authorized for listing on the New York Stock Exchange (NYSE), the American Stock Exchange (Amex); the Nasdaq National Market System (NMS) list; or securities exchanges registered with the SEC (or any tier or segment of

their trading) if the SEC determines by rule that their listing standards are substantially similar to those of the NYSE, Amex, or Nasdaq National Market System, which the SEC has done through Rule 146; and any security of the same issuer that is equal in seniority or senior to any security listed on the NYSE, Amex, or Nasdaq NMS list;

(2) Securities issued by an investment company registered with the SEC (or one that has filed a registration statement under the Investment Company Act of 1940);

(3) Securities offered or sold to "qualified purchasers." This category of covered securities will become operational only when the SEC defines the term "qualified purchaser" as used in Section 18(b)(3) of the Securities Act of 1933, by rule. To date the SEC has proposed, but not adopted, Rule 146(c) of the Securities Act of 1933; and

(4) Securities issued under specified exemptions of the Securities Act of 1933:

(A) Sections 4(1) (transactions by persons other than an issuer, underwriter or dealer), and 4(3) (dealers after specified periods of time), but only if the issuer files reports with the Commission under Sections 13 or 15(d) of the Securities Exchange Act;

(B) Section 4(4) (unsolicited brokerage transactions);

(C) Securities Act exemptions in Section 3(a) with the exception of the charitable exemption in Section 3(a)(4), the exchange exemption in Section 3(a)(10), the intrastate exemption in Section 3(a)(11), and the municipal securities exemption in Section 3(a)(2) but only with "respect to the offer or sale of such [municipal] security in the State in which the issuer of such security is located"; and

(D) Securities issued in compliance with SEC rules under Section 4(2) (private placements) such as Rule 506 of Regulation D.

This list includes the vast preponderance of major United States issuers. For example, in 2001, 99.9 percent of the $11.2 trillion in stocks listed on the New York, American, or other stock exchanges were listed on the New York or the American Stock Exchange.[18]

Section 18(c)(1) preserves state authority "to investigate and bring enforcement actions with respect to fraud or deceit, or unlawful conduct by a broker or dealer, in connection with securities or securities transactions."

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[18] SEC, Ann. Rep. 178 (2002). The Nasdaq market was smaller with a capitalization of $2.9 trillion in 2001, see SIA, *Securities Industry Fact Book* (2002) at 48; mutual funds, which are covered securities under §18(b)(2) added another $3.4 trillion in equity assets in 2001. *Ibid* at 59. Exempt securities, some of which would be noncovered, are smaller in aggregate capitalization. In 2001, for example, there were 2,868 private placements in the United States with a total capitalization of $581.2 billion. *Ibid* at 13.

The States, with specified exceptions, are authorized by §18(c)(2) to require filings of any document filed with the SEC for notice purposes "together with annual or periodic reports of the value of securities sold or offered to be sold to persons located in the State (if such sales data is not included in documents filed with the Commission), solely for notice purposes and the assessment of any fee, together with a consent to service of process and any required fee."

NSMIA, in essence, preempts aspects of the securities registration and reporting processes for specified federal covered securities. NSMIA can be viewed as supplanting the earlier registration by coordination process for all covered securities with a new federal statute that generally accomplishes the same result. Registration by coordination may continue to be used by the states for noncovered securities. The different treatment between a covered security and a noncovered security is however legally significant. The states are preempted from experimentation with respect to covered securities. The states have discretion in how to address noncovered securities and can unilaterally adopt registration by coordination procedures. The Act does not diminish state authority to investigate and bring enforcement actions generally with respect to securities transactions.

With respect to broker-dealers, NSMIA added §15(h)(1) to the Securities Exchange Act of 1934 to preempt state law from "[establishing] capital, custody, margin, financial responsibility, making and keeping records, bonding, or financial or operational reporting requirements for brokers, dealers, municipal securities dealers, government securities brokers, or government securities dealers that differ from, or are in addition to the requirements in those areas established under [the Securities Exchange Act]." In one fell swoop, §15(h)(1) bars all state broker-dealer capital, custody, financial responsibility, recordkeeping, and reporting requirements that go beyond those of the federal Securities Act. Subject to this limit, the states, however, are permitted to register broker-dealers and bring enforcement actions.

Title III of NSMIA, separately titled The Investment Advisers Supervision Coordination Act, took a different approach with respect to investment advisers. NSMIA, by statute, solely subjects to state regulation advisers with assets under management of $25 million or less. Any adviser with assets under management of $25 million or more will register solely under §203 of the Investment Advisers Act and not state law. This division of labor was intended to eliminate duplicative regulation of investment advisers.[19]

NSMIA also made significant amendments to the securities loan or credit provisions of the Securities Exchange Act of 1934.

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19 Title II of the National Securities Markets Improvement Act amended the Investment Company Act to address:
- (1) funds of funds in §12(d)(1);
- (2) the registration of indefinite amounts of securities in §24(f);
- (3) the facilitation of current information in advertising, see new §24(g);
- (4) variable insurance contracts, see new §§26(e) and 27(i);
- (5) reports to the Commission and shareholders, §30;
- (6) books, records, and inspections, §31;
- (7) prohibition of deceptive investment company names, §35(d); and
- (8) amendments to definitions, see §3(c), new §2(a)(51(A) ("qualified purchases").

As a general matter, NSMIA did not cause states to reduce the size of their securities regulatory bodies, despite the increased scope of federal preemption that NSMIA introduced. The states generally shifted resources to increased enforcement that were formerly devoted to preempted regulatory activities.

2. Practical Implications of the Current Structure of United States Federal and State Securities Regulations

After NSMIA the federal securities laws employ three separate methods to coordinate federal-state securities laws:

1. Specified aspects of the registration and periodic reporting of covered securities, broker-dealer regulation, and investment adviser registration and regulation are *preempted* in full or in part by NSMIA.

2. Enforcement remains subject to *concurrent federal and state regulation* under express provisions preserving the jurisdiction of state securities commissions. The Securities and Securities Exchange acts, for example, specifically save "all other rights and remedies that may exist at [state] law or in equity."[20]

3. Section 19(c) of the Securities Act of 1933 authorizes the SEC to cooperate, coordinate, and share information with "any association composed of duly constituted representatives of state government whose primary assignment is the regulation of the securities business within those states,"[21] an elaborate way of referring to the North American Securities Administrators Association (NASAA) that operates in both Canada and the United States.

These different types of federal-state securities coordination methods function differently with respect to (a) policy development; (b) enforcement; and (c) regulatory flexibility.

(a) *Policy Development*

Sections 19(c)(2) and (3) of the Securities Act stress a federal policy that emphasizes "maximum uniformity in Federal and State regulatory standards."[22] In particular cooperation is encouraged between the SEC and NASAA in three specified areas:

1. the sharing of information regarding the registration or exemption of securities issues applied for in the various States;

2. the development and maintenance of uniform securities forms and procedures; and

3. the development of a uniform exemption from registration for small issuers which can be agreed upon among several States or between the States and the Federal

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20 See Sec. Act §§16(a), 18; Sec. Exch. Act §28(a); Inv. Adv. Act §222; Inv. Co. Act §50.

21 Sec. Act §19(c)(1).

22 Sec. Act §19(c)(2)(B).

> Government. The Commission shall have the authority to adopt such an exemption as agreed upon for Federal purposes. Nothing in this Act shall be construed as authorizing preemption of State law.[23]

In recent years, cooperation has been a mantra of both United States federal-state securities policy development and efforts by the states to harmonize state policies.

In 2002 a new version of the Uniform Securities Act was adopted by the National Conference of Commissioners on Uniform State Laws. The Uniform Securities Act has been the model for close to 40 states' securities laws. NASAA endorsed the 2002 Uniform Securities Act including §608, a reciprocal provision to §19(c) of the Securities Act of 1933. Section 608(b)(2) provides that the securities administrators "shall, in its discretion, take into consideration in carrying out the public interest . . . maximizing uniformity in federal and state regulatory standards."[24]

Consistent with the intent of such provisions as §19(c) of the Securities Act of 1933 and §608 of the 2002 Uniform Securities Act, the SEC and NASAA have adopted uniform forms (for example, Form BD for broker-dealer registration; Form ADV for investment adviser registration); cooperated with the NASD on one stop filing procedures for broker-dealers (the Web-CRD or Central Registration Depository) and investment advisers (the IARD or Investment Advisers Registration Depository); and worked jointly to adopt the Uniform Limited Offering Exemption (currently adopted in 50 of 53 United States jurisdictions) which works in tandem with the SEC's Regulation D securities registration exemptions.

Critical aspects of joint policy development are less formal. Section 19(c)(4) further specifies "in order to carry out these policies and procedures" that the SEC shall conduct an annual conference as well as other meetings to which, among others, NASAA representatives

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[23] Sec. Act §19(c)(3).

[24] Section 608(c) provides in detail:

> The cooperation, coordination, consultation, and sharing of records and information authorized by this section includes:
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> (1) establishing or employing one or more designees as a central depository for registration and notice filings under this [Act] and for records required or allowed to be maintained under this [Act]:
> (2) developing and maintaining uniform forms;
> (3) conducting a joint examination or investigation;
> (4) holding a joint administrative hearing;
> (5) instituting and prosecuting a joint civil or administrative proceeding;
> (6) sharing and exchanging personnel;
> (7) coordinating registrations under Sections 301 and 401 through 404 and exemptions under Section 203;
> (8) sharing and exchanging records, subject to Section 607;
> (9) formulating rules, statements of policy, guidelines, forms, and interpretative opinions and releases;
> (10) formulating common systems and procedures;
> (11) notifying the public of proposed rules, forms, statements of policy, and guidelines;
> (12) attending conferences and other meetings among securities regulators, which may include representatives of governmental and private sector organizations involved in capital formation, deemed necessary or appropriate to promote or achieve uniformity; and
> (13) developing and maintaining a uniform exemption from registration for small issuers, and taking other steps to reduce the burden of raising investment capital by small businesses.

shall be invited to participate." Since 1984 these annual conferences on federal securities regulation have addressed a wide array of mutual concerns.[25]

The NASAA has been a particularly frequent and influential commenter on SEC rule and form proposals. NASAA is a membership organization of United States state and Canadian province securities regulators, with a centralized staff in Washington, D.C., that holds annual and other meetings and frequently adopts statements of policy, resolutions, and provides comment letters to the SEC and testimony to the United States Congress. For example, in 2001 the Commission adopted Rule 17a-3(a)(17) to require broker-dealers to create records containing minimum customer account information. The adoption Release stated in part:

> The primary purpose of Rule 17a-3(a)(17) is to provide regulators, particularly State Securities Regulators, with access to books and records which enable them to review for compliance with suitability rules. . . . The rule should not be construed to affect or supersede any federal, State, or SRO requirement, including those relating to "know your customer," suitability, or supervisory obligations.[26]

The degree of federal-state cooperation in securities regulation should not be overstated. There are important policy differences on occasion between the SEC and the NASAA or among the states themselves. As significant as policy differences has been the enthusiasm of the SEC Chairman for working with the states. To cite perhaps the most significant recent illustration of both points, in October 1995, SEC Chair Arthur Levitt announced his opposition to the initial version of what became the 1996 NSMIA Act with a speech to NASAA urging cooperation in six areas: investment advisers, investment companies, registration of brokers, examination of brokers, registration of corporate securities, and enforcement authority. NASAA representatives were disappointed both by the substance of what Levitt urged and with the lack of prior consultation.[27] From NASAA's point of view Levitt appeared to be compromising traditional areas of investor protection. Levitt viewed NSMIA as a compromise between the initial bill that was introduced and the NASAA position.

To put this in different terms, the SEC has not acted as if constrained by the statutory emphasis on cooperation when responding to emerging market needs when they were time

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[25] See Loss & Seligman, *supra* note 2 at 46 n46. In April 2003 the Commission and NASAA met to discuss a jointly developed agenda that included:

(1) Corporation Finance issues including eight new SEC rules to implement the Sarbanes-Oxley Act and including particular issues raised by smaller issuers; transactions involving "qualified purchasers"; the Regulation A securities exception; Form D; and blank check securities;

(2) Market Regulation issues including bank-dealer exemptions from the securities laws; possible revisions to Form BD; research analyst conflicts of interest; settlement cycles and processing; IPO underwriting and allocation; CRD expungement; New York Stock Exchange proposals to redefine branch offices and supervisory systems; recent amendments to broker-dealer recordkeeping rules; and examination issues; and

(3) Investment Management issues including electronic filing in the IARD and examination of investment advisers. Sec. Act Rel. 8207, 79 SEC Dock. 2352 (2003).

[26] Sec. Ex. Act Rel. 44,992, 76 SEC Dock. 343, 347 (2001).

[27] Joel Seligman, *The Transformation of Wall Street: A History of the Securities and Exchange Commission and Modern Corporate Finance*, 3d ed. (2003) at 674-681.

sensitive. But as a general matter the Commission is required by the federal Administrative Procedure Act to employ notice and comment processes before adopting new rules. The statutory emphasis on federal-state cooperation has generally become part of this analysis. While states' comments are taken seriously, so are those of other federal agencies, industry, and investors. The process does somewhat slow and modify federal action.

Under the United States Constitution Supremacy Clause when there is a conflict between the SEC and the states, the SEC as a legal matter will prevail when there is a federal securities statute or rule and simultaneous compliance with a state law "is a physical impossibility"; the state law "stands as an obstacle to the accomplishments and execution of the full purposes and objectives of Congress"; or the state law "frustrates the purposes of the federal law."[28] As a practical matter, the SEC has been constrained in relying on the Supremacy Clause, particularly by its need to work with the states in enforcement matters where the SEC has often been understaffed.

For the most part the SEC has largely deferred to the states on intrastate and local policy issues. It was striking, for example, that the SEC did not participate in the 1978-1985 unsuccessful effort to rewrite the Uniform Securities Act and did not attempt to impose any policy position not required by federal statute in the 1998-2002 effort to rewrite the Uniform Securities Act.

(b) *Enforcement*

Enforcement remains the area of federal and state securities law that continues the most complete degree of concurrent regulation. While the United States Congress in the Private Securities Litigation Reform Act of 1995 and the Securities Litigation Uniform Standards Act of 1998[29] has limited private securities class actions at both the federal and state level, NSMIA expressly preserved state securities commission authority "to investigate and bring enforcement actions with respect to fraud or deceit or unlawful conduct . . . in connection with . . . securities transactions."[30] Indeed §102(c) of the Securities Litigation Uniform Standards Act of 1998 attempted to augment state enforcement power with a hortatory provision calling for reciprocal subpoena enforcement.

The major issues with respect to federal state securities enforcement have been at the level of lore rather than law. There is an implicit nonstatutory assumption that the states will largely enforce intrastate and smaller claims and the SEC will primarily enforce interstate and larger claims. States bring a larger volume of enforcement actions than does the SEC, but these actions tend to be smaller (in terms of the dollar amounts at issue), involve individual defendants, and often relate to failures to register securities, individual broker-dealers, or individual investment advisers. SEC enforcement actions tend to be larger (in terms of the dollar amounts at issue), involve multiple defendants, and relate to a wider range of claims.

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[28] *CTS Corp. v. Dynamics Corp. of Am.*, 481 U.S. 69, 78-79 (1987).

[29] 10 Louis Loss & Joel Seligman, *Securities Regulation*, 3d ed. (1996) at 4636-4669; Louis Loss & Joel Seligman, *Securities Regulation* (2003 Ann. Supp.) 29-38.

[30] Sec. Act §18(c)(1).

Occasionally there has been frustration with this nonstatutory assumption either because particular states have been inadequately funded to perform a meaningful enforcement role[31] or when the SEC has expressed concerns about state security commissions or Attorneys General addressing major *interstate* claims such as the 2002 settlement that New York Attorney General Eliot Spitzer negotiated with Merrill Lynch because of its research analysts misconduct.[32] As a general matter the two most serious ongoing enforcement issues have been inadequate enforcement budgets in many states and periodically at the SEC. When there are significant increases in fraud, as there appeared to be in late 1990s, many states and the SEC can be overwhelmed. This can lead to inconsistent policy with respect to interstate cases.

At the same time, the New York State criminal case against research analysts is a useful illustration of a key virtue of concurrent enforcement. SEC Chair Arthur Levitt was criticized for not adequately investigating broker-dealer research analysts during the late 1990s.[33] Precisely because the states also had investigatory and enforcement powers, one state was able to take up the slack and initiate what became a $1.4 billion settlement with ten leading broker-dealer firms.[34] Ultimately the SEC worked smoothly with the NASAA, NASD, and the State of New York on the Global Research Analyst Settlement.[35]

The Spitzer initiative against investment advisers and 1980s efforts by the United States Attorney for the Southern District of New York Rudolf Giuliani against insider traders do suggest there is a risk securities cases can be taken up by prosecutors who are believed to have political ambitions. This is a conventional risk which occurs in nonsecurities cases as well. Abuse is generally limited by judicial oversight.

(c) *Regulatory Flexibility*

At a statutory level there is a sharp distinction between topic areas where federal law preempts state law (such as merit regulation standards applied to covered securities) and concurrent regulation where state rulemaking authority is largely unfettered.

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31 See data in Loss & Seligman, *supra* note 2 at 147-150.

32 "Merrill Lynch, Spitzer Reach Interim Deal; New Securities Research Disclosures Ordered" (2002) 34 Sec. Reg. & L. Rep. (BNA) 647.

33 See Seligman, *supra* note 27 at 648.

34 "Wall Street Agrees to $1.4 Billion Payment, Broad Reforms, Resolving Conflict Charges" (2002) 34 Sec. Reg. & L. Rep. (BNA) 2037.

35 SEC Press Rel. 2003-54 (Apr. 28, 2003). Subsequently, H.R. 2719 was introduced in the United States House of Representatives to require states in specified circumstances to remit to the SEC penalties and disgorgement obtained in state actions for distribution to investors and to prevent securities law violators from shielding property from the SEC under state homestead laws. NASAA President Christine Bruenn testified on June 5, 2003 that she anticipated that NASAA would be able to work with the SEC and the House Subcommittee to address concerns about the Bill. It is uncertain whether the Bill will be enacted. "Lawmakers, Witnesses at House Hearing Anticipate Resolution of States' Rights Issues" (2003) 35 Sec. Reg. & L. Rep. (BNA) 952. In July 2003 a similar controversy arose when a House subcommittee approved a Bill that would limit state rulemaking with respect to research analysts' conflicts of interest. "States, Intent on Regulating, Look at Morgan" *N.Y. Times* (July 15, 2003) C1. It is uncertain whether this Bill will be adopted by Congress. "Solomon & Smith, Donaldson Asserts SEC Authority on Markets" *Wall St. J.* (July 16, 2003) C1.

In practice the distinction is somewhat less sharp. Under §18(b)(3) of the Securities Act, for example, the SEC could significantly expand the categories of securities preempted from state merit standards by adopting a rule defining the term *qualified purchaser*. NASAA opposed an initial SEC proposal that would have reached natural persons with net worth of $1 million *or* income of $200,000 because NASAA believed this would increase the risk of defrauding natural persons. To date the SEC has desisted in either adopting the proposal or reproposing it.[36] Ultimately the SEC may adopt a definition of *qualified purchaser* without including natural persons or with higher net worth and income thresholds.

On the other hand, when states are not subject to NSMIA's preemptive provisions, the states have often taken, as an SEC report explained, "significant actions to enforce uniformity in regulating offerings of securities that are both 'covered' and 'not covered.'" These include coordinated review of filings, a uniform registration statement for offerings that are exempt at the federal level, and statements of policy on a number of review issues that enhance uniformity of review in the states.[37]

The basis for this dulling of the state rulemaking authority distinction between preemptive and concurrent statutory provisions seems three-fold.

First, implicitly both federal and state securities laws share common purposes to maximize investor protection while minimizing interference with capital formation.[38] At times both the federal SEC and many states have been underfunded and often shared an ethos that they are allies with each other protecting investors rather than with industry, with which each generally works well, but warily.

Second, at least since the 1956 Uniform Securities Act, most of the states have recognized that support for uniform state standards and coordination with federal law further reduces the likelihood of federal preemption.[39] This point was powerfully illustrated when the failure of the states to agree with the securities industry on a common approach to merit review and securities registration exemptions prompted Congress in 1996 to enact NSMIA. Before NSMIA, but after the 1994 Congressional elections, NASAA did create a Task Force on the Future of State and Federal Securities Regulation (including the author), whose primary implicit purpose was to find compromise positions acceptable to both NASAA and proponents of federal preemption and to discourage the United States Congress from acting. The political landscape was so significantly changed by the 1994 United States Congressional elections that this effort at compromise failed.

Third, pivotal aspects of state securities law, particularly with respect to novel products or practices, repose in NASAA statements of policy, which can be adopted at the state law level as

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[36] Sec. Act Rel. 8041, 76 SEC Dock. 1035 (2001) (proposal); NASAA Comment Letter, NASAA Rep. ¶13,095 (Mar. 4, 2002).

[37] SEC Rep., Uniformity of State Securities Requirements for Offerings of Securities that Are Not Covered Securities (1997), summarized in Loss & Seligman, *supra* note 29 at 23-26.

[38] Cf. Sec. Act §19(c)(2)(B)-(C); Unif. Sec. Act (2002) §608(b)(1) & (3).

[39] Cf. Unif. Sec. Act (1956) §415; Unif. Sec. Act (2002) §608(a).

state rules or guidelines.[40] Currently there are over 60 such NASAA statements. The flexibility that these statements provide in the rapidly changing security marketplace has been recognized as essential to securities regulation not only by NASAA, but also by such industry representatives as the Securities Industry Association (SIA) and the American Bar Association (ABA). Both the SIA and the ABA endorsed the New Uniform Securities Act (2002) including §203 which authorizes the securities administrator to grant additional exemptions and waivers and §204(a), which in specified instances, authorizes the administrator to deny, suspend, revoke, condition or limit existing exemptions.

3. Conclusion

While the United States federal-state system of securities regulation may appear reticulate, if not Byzantine, a core reality is that it generally has worked well. Both the SEC and the states perceive advantages to having more, rather than fewer, regulators involved, particularly to review filings, conduct examinations, and bring enforcement actions. Both the SEC and the states have usually recognized that contradictory state policies or conflicts with the SEC may deter investment in the United States and strengthen the case for federal preemption. Both the SEC and the states take pride in the growth of the United States securities market and the number of direct and indirect investors under a regulated federal-state system.

Given the institutional realities, both the SEC and NASAA have emphasized consultation, whether formally through periodic conferences, or less informally through NASAA comments on SEC rule and form proposals, or meetings or telephone calls on specific topics such as enforcement cases. It is the informal shared values and coordination that is pivotal to making the United States system work as well as it does.

It is worth emphasizing that the United States federal-state securities regulation system preserves a great deal of flexibility for each state to address local concerns. Under NSMIA preemption has not occurred with respect to noncovered securities. Virtually all intrastate and smaller offers are subject to state requirements that vary from state to state. A key area of controversy has been the disclosure requirements under Rule 506 and Regulation D which are limited by NSMIA to those required under federal law.[41] For the most part, however, state merit and escrow standards and state denial, suspension, or revocation of securities standards are untouched by federal law for noncovered securities. State securities fraud enforcement is not preempted.

NSMIA cuts more deeply with respect to regulation of broker-dealers registered under federal law. Section 15(h)(1) of the Securities Exchange Act precludes the states from adopting capital, custody, margin, financial responsibility, recordkeeping, bonding, or financial reporting requirements for broker-dealers the differ from these adopted by the SEC. But §15(h)(1) only

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40 See NASAA Rep. ¶¶351-3841.

41 Sec. Act §18(b)(4)(D). Rule 506 is a qualified exemption from the securities registration requirements of the Securities Act of 1933 and is part of Regulation D (which includes Rules 501-508 under the Securities Act of 1933). To qualify for the Rule 506 exemption, there are specified disclosure requirements. The states did adopt a parallel Uniform Limited Offering Exemption (ULOE). But there was disappointment on the part of some securities issuers when additional disclosure requirements were added for some states.

addresses broker-dealer firms that are registered with the SEC. Federal unregistered broker-dealers are solely subject to state law which can adopt different standards. Registered representatives or agents who work for either registered or unregistered broker-dealers are solely subject to state regulation. The state may bring fraud actions against any registered or unregistered broker-dealer firms or any registered representative.

Similarly, with respect to investment advisers, NSMIA did preempt state registration and regulation above a specified assets under management threshold. But the states may bring enforcement actions against those advisers and are not limited in registration or regulation of investment advisers below the assets under management threshold. The states alone register and regulate investment adviser registered representatives including those that work for federally registered investment advisers.

Even after NSMIA, the United States federal-state securities regulation system preserves state autonomy with respect to intrastate or local securities offerings, broker-dealers, and investment advisers, but establishes federal standards for covered securities, broker-dealer firms registered under the Securities Exchange Act, and investment advisers above a specified assets under management threshold.

To be sure there are costs to the concurrent system of regulation.[42] There can be redundant regulatory efforts including multiple fees for securities issuers and professionals. For the SIA this is a key concern and one basis for it supporting the Uniform Securities Act (2002) which may lessen the number of relevant state fees. Federal and state policies can also be contradictory as they were with respect to state merit regulation of securities issues or the initial different enforcement strategies with respect to investment analysts. Both the federal government and the states can rationalize underfinancing securities regulation on the logic that it is addressed by a different layer of government. This has been a particularly challenging question with small enforcement actions in states which have inadequate enforcement budgets. Coordination with 50 states can delay federal rule or form adoption and may be complex given different state policies. The significance of these types of costs varies over time. But, on balance, even with these costs, the United States federal-state model of securities regulation has generally been perceived to work well.

If presented with the opportunity to design a regulatory structure for the United States on a clean slate, I would retain concurrent federal-state jurisdiction. The creation of the SEC in 1934 was a response to the shortcomings of state-only regulation in the period from 1917 to 1934 with respect to enforcement of interstate claims, coordination among state regulators, inadequate budgets for state regulators, and what has been termed the resulting "balkanization" of state securities regulation. The state role in United States securities regulation exists today not solely because of path dependence (i.e., the historical fact of state securities regulation), but also because of the demonstrated benefits of state regulation, particularly the importance of the state role in intrastate enforcement.[43]

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[42] I am, however, unaware of cost-benefit studies relating to concurrent state and federal regulation.

[43] See *supra* notes 9-12 and accompanying text.

Regulation by the SEC alone could lead to important gaps in the regulator's ability to enforce securities laws and a corresponding adverse impact on investor confidence. As the SEC's budget and resources have fluctuated in the past, the "fraud waves" that have occurred might have been even worse had there been no state enforcement resources to supplement those of the SEC. In designing a new concurrent structure, I would focus on identifying those matters that most appropriately should be regulated at the state and federal levels, particularly addressing the significance of local issuances and fraud on the one hand and national or international offerings and broker-dealer firms on the other.

Securities Market Regulation in the EU: The Relation Between the Community and Member States

Research Study Prepared for the
Wise Persons' Committee

Karel Lannoo and Mattias Levin
Centre for European Policy Studies (CEPS)

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Securities Market Regulation in the EU:
The Relation Between the Community and Member States

Biographies

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Karel Lannoo has been chief executive of the Centre for European Policy Studies (CEPS) since 2000 and senior research fellow since 1997. CEPS is the leading European think tank, employing a staff of about 50 persons in Brussels, and running research networks with institutes from a variety of countries.

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Securities Market Regulation in the EU:
The Relation Between the Community and Member States

Executive Summary

One of the fundamental aims of the European Union (EU) is to construct an internal market, composed of the home markets of all member states. In order to achieve this, member states have delegated significant powers to supranational community institutions: the European Commission, the European Court of Justice (ECJ) and the European Parliament. However, while member states have delegated powers, they nevertheless subject that delegation to significant constraints and they retain a considerable amount of responsibility for policies which may affect the running of such an internal market. This tension is at the heart of all discussions concerning the distribution of competence between the Community on the one hand and the member state authorities on the other hand, be it in any policy area, but very much so in securities market regulation.

The ways to achieve a single market have changed over the years. From the 1960s to the mid-1980s, the Commission and member states tried to achieve extensive harmonisation in order to bring about market integration. Such efforts being extremely slow and ineffective, the EU has since the mid-1980s followed another approach to create an internal market, based on minimal harmonisation and mutual recognition. By and large, this new approach managed to bring about a reasonably integrated internal market by the end of 1992.

Nevertheless, by the mid-1990s it became apparent that the new approach had not delivered sufficiently in the different areas of financial services, as significant obstacles to the provision of cross-border financial services remained, particularly in the area of securities markets. This was highlighted by the start of monetary union in 1999. As a result, the EU set itself the objective of updating existing financial regulation and adopting new laws in order to eliminate remaining regulatory obstacles for a pan-European financial market, the so-called Financial Services Action Plan (FSAP). In order to achieve that aim, the EU also agreed to modify the way it enacts laws in the securities market field. These changes are currently being expanded to other areas of finance as well.

Thanks to the FSAP and the new regulatory structure, the EU is closer to its goal of achieving an internal market for financial services. Whether it will work remains to be seen, but some problems can already be noticed. First, the new legislative procedure is complex, and the consensus around it is fragile. Considerable effort will need to be exercised by the European Commission to maintain the balance between the different institutions involved, and to rein in its own ambitions. Secondly, the principles on which the new procedure is based are not set in stone, but will continue to vary depending on the circumstances. A continuous evaluation of objectives and achievements is therefore required.

Securities Market Regulation in the EU:
The Relation Between the Community and Member States

1. Introduction

Canada, a federal state, is currently grappling with defining the structure for regulating and supervising financial markets in general and securities markets in particular.[1] There are a number of issues raised when it comes to allocating authority in a structure with several levels of political actors. For example, how much power should be centralised? What influence should sub-entities have over the overarching authority? What freedom of manoeuvre should sub-entities have? To what extent should the central power have the authority to rein them in?

While contexts are naturally different, these issues bear striking similarities to the issues dwelled and acted upon in Europe during the last decades of constructing an effective internal market. The aim of this study is to provide an overview of how the overarching aim of constructing an internal market has affected the location of political authority in the European Union (EU).[2] A first part will look at how this discussion has developed generally, while a second part will look at current discussions regarding one of the areas that have been hard to integrate: financial services, and more especially securities markets.

2. Building the Internal Market

One of the fundamental aims of the EU is to construct an internal market, composed of the home markets of all member states. Judging themselves incapable of reaching that goal, member states set up a community, since 1992 called the European Union (EU). They have thereby delegated significant powers of initiation, interpretation, execution and enforcement[3] to two supranational community institutions in particular: the European Commission and the European Court of Justice (ECJ).[4] However, while member states have delegated powers, they nevertheless subject that delegation to significant constraints and they retain a considerable amount of responsibility for policies which may affect the running of such an internal market. This tension is at the heart of all discussions concerning the distribution of competence between the Community on the one hand and the member state authorities on the other hand, be it in any policy area, but very much so in securities market regulation.

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1 Harris (2002).

2 Limited space does not permit an overview of the basic functioning of the European Union and all its institutions. For a concise description, please consult "How the European Union Works" by the European Commission (2003b) or "The ABC of Community Law", Borchardt (2000).

3 As used in this study, the term "enforcement" refers, unless stated otherwise, to the need to ensure that EU member states implement and interpret harmonized requirements in a manner that supports the goal of an internal market for securities, and so refers to issues arising between member states, as opposed to matters arising within a member state as a result of non-compliance by a regulated individual or organization.

4 Tallberg (2002).

(a) *The Legal Basis*

The Treaty establishing the European Community (TEC) prohibits all restrictions to the free movement of goods, services, capital and labour. Member states therefore have the *right of access* to other member states' markets. However, such a right in isolation has historically proven to be insufficient in reining in member states' ability to impose new barriers to trade. This was especially the case, as coupled with the aim to construct a single market, the TEC provides for a number of exceptions to the free access and movement articles. For example, article 30 (TEC) granted member states the right to impose quantitative restrictions on imports and exports for e.g. health and safety reasons.[5]

In order to reign in the potential of such restrictions hampering the internal market, a legal principle has been developed by the European Court of Justice (ECJ), which reinforces the right of access. The *mutual recognition* principle, established by the ECJ in the Cassis de Dijon (1979) case, states that products or services that have been lawfully produced and marketed in a member state are to be granted free access throughout the internal market, without authorities in other member states imposing further conditions.[6] Moreover, the TEC granted the EU the possibility to issue directives to "approximate", or *harmonise* in common EU parlance, those laws, regulations and administrative provisions that affect the establishment and functioning of the internal market (Art. 94, TEC). However, (i) the extent to which mutual recognition has been relied upon and (ii) the ease by which member states can harmonise laws has evolved over time.

(b) *Extensive Harmonisation – The Classical Approach*

On the basis of Article 94, the European Commission in 1968 set out to harmonise various technical aspects of goods produced in EU member states. Continuing until the early 1980s, this approach was spectacularly unsuccessful. Producing roughly ten directives a year, the chosen method was time-consuming and costly and failed to dent, let alone reduce, barriers to trade.[7] There were many reasons behind this failure to improve market access, notably related to (i) the unanimity requirement for agreeing on legislative acts, (ii) excessive ambitions of uniformity at community level and (iii) a lack of political interest by member state ministers.

(c) *The "New Approach" – Minimal Harmonisation*

Frustrated with the lack of improvement in market access, the Commission in 1983 put forward a radically different proposal for achieving a dismantling of technical barriers to trade in the Mutual Information Directive of 1983. It was directly built on the mutual recognition principle, established by the ECJ, and provided for a more formal process of consultation and

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[5] This right was never a blank cheque, but subject to stringent requirements, as established by ECJ case law. See Pelkmans (1987) for further details.

[6] ECJ, Case 120, 78 of 20 February 1979; See Pelkmans (1987) and Sun and Pelkmans (1995).

[7] Pelkmans (1987).

peer vetting before adopting technical standards instead of relying on reaching unanimous agreement on what common standard should apply.[8]

Building on this at first sight unimportant directive, the 1985 White Paper incorporated these principles. It provided that future legislative activity should be limited to harmonising essential measures, beyond which mutual recognition should apply.[9] It put forward around 280 legislative measures that should be harmonised. The White Paper was supplemented by far-reaching changes to the EU's decision-making procedures. The Single European Act (SEA) put forward changes to the Treaty, thereby rendering it easier to implement the White Paper's legislative measures. The SEA increased the Community's capacity for action by introducing qualified majority voting instead of unanimity as the basis for adopting measures aimed at accomplishing the internal market (Article 95 and 251). Later revisions to the Treaty have further changed the decision-making process. A persistent aim of these changes – decided by an Inter-Governmental Conference (IGC) – has been to increase capacity for action. Another aim has been to increase the powers of the European Parliament.[10]

This new approach should be seen as a pragmatic response to defusing the previously "all-or-nothing" character of harmonisation. It (i) opened markets in spite of the continued existence of national regulation and (ii) removed or pre-empted the erection of barriers to trade.[11] It put in place a system where the futile quest for a definite and intellectually clear allocation of political authority was replaced with constructive ambiguity. Regarding the ambiguous element, it is illustrative that the new approach was greeted by member states previously having resisted further market opening as a way of retaining regulatory control over international markets while other member states, having argued in favour of market access, heralded the forces of liberalisation it unleashed.[12] The major accomplishment of the new single market approach is therefore that it defused the political tensions related to further market opening.

By 1992, the new approach had proved its constructive element as well, as member states had adopted the large majority of the measures put forward in the White Paper, thereby taking one step closer to an internal market. The major contribution of the new approach was therefore that it brought together those stressing harmonisation as a response to international market forces and those promoting competition among rules as the proper reply.[13]

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8 *Ibid.*

9 European Commission (1985).

10 The Treaties governing the European Union have been revised following decisions by IGCs in Maastricht (1992), Amsterdam (1997) and Nice (2001). A proposal for a more fundamental revision of the treaties has just been put forward by the European Convention to the member states. A forthcoming IGC is scheduled to decide on this proposal later this year or early 2004.

11 Sun and Pelkmans (1995).

12 Woolcock in Ogus (2001).

13 *Ibid.*

The EU "Passport" for Financial Services

The EU scheme is frequently termed a "passport" system. As is explained in detail in the text of this study, the "mutual recognition" principle is at the heart of the EU system: products or services that have been lawfully produced and marketed in a member state are to be granted free access throughout the internal market, without authorities in other member states imposing further conditions.

In principle, an effective mutual recognition system has the following elements:

1. harmonization of minimum technical standards to eliminate host regulators' ability to refuse recognition of home regulators' requirements;
2. a method to ensure that the harmonized minimum standards are implemented and interpreted consistently in all participating jurisdictions, and to cause non-complying jurisdictions to comply; and
3. a means for regulated individuals or organizations to alert other jurisdictions to non-compliant implementation and/or interpretation without fear of reprisals from regulators.

Each of these elements has its own requirements. For example, the harmonized standards must be sufficiently detailed and complete in order to prevent objections by host regulators arising from lacunae in the harmonized standards. International standards, including the IOSCO Objectives and Principles of Securities Regulation, frequently do not meet this requirement, and so it is necessary to develop them among the participating jurisdictions. As noted in the body of this study, however, requiring a high degree of detail in the harmonized standards may prevent agreement, but insufficient harmonization also undermines such a system.

With respect to enforcing the implementation and interpretation of harmonized standards in a manner that permits effective mutual recognition, there must be some central or at least coordinated response and penalties for non-compliance. Permitting jurisdictions to withdraw from the scheme, in whole or in part, as an alternative to complying would largely defeat the purpose of the scheme.

In the case of financial services, the mutual recognition principle operates more effectively in some areas than in others. For example, the requirements applicable to investment funds (known as UCITS, or "undertakings for collective investments in transferable securities") have been subject to effective mutual recognition since approximately 1987, and, as a result, Luxembourg and Ireland have emerged as centres for the design and creation of such products for "export" to other EU states without additional national regulatory requirements. Also in banking the single passport, introduced as a result of the second banking directive, works effectively. Banks can offer services and open branches across borders with a single licence.

The regulation of market intermediaries under the Investment Services Directive, however, has been less successful in reducing host jurisdiction regulation. Host jurisdictions, for example, generally impose additional restrictions on solicitation and implement local conduct of business rules in addition to those of the home jurisdiction. As a result there is a debate as to the effectiveness of mutual recognition in this area. Even so, following the adoption of the ISD in 1993, the provision of services across the border has increased exponentially, as illustrated by the increase in notifications by service providers to host country supervisors.

Mutual recognition has worked the least in the regulation of issuers and securities issuances. Under the current Prospectus Directive, the host jurisdiction may, in recognizing a prospectus, require additional information related to the domestic market (including translation into host country languages, details of local tax treatment, etc.).

The EU "Passport" for Financial Services (cont'd)

Recent EU activity addresses these limitations. The new Directive on Prospectuses, adopted in July 2003 by the European Parliament, will replace the existing Prospectus Directive and Listing Particulars Directive and introduces a single prospectus system for securities issuances in the EU, following the maximal harmonisation approach. The European Commission has also launched an extensive review of the Investment Services Directive in order to complete the single passport for investment firms, and released a new draft directive in November 2002. The proposed Directive strengthens the home country control principle and only retains a role for host jurisdiction regulators in limited areas, including, in respect of branch operations, enforcing requirements relating to keeping records of services provided and transactions with clients of the branch and for enforcing the business conduct rules.

(d) *Implications for Allocation of Competencies*

The new approach embodied in the single market project affected the distribution of power between member states on the one hand and member states and the Community institutions on the other hand.

Delegation Subject to Control[14]

The single market approach has entailed a more significant delegation of power to the supranational institutions, charged with pushing forward policies that attain the objective of constructing a single market. Nevertheless, the degree to which power has been delegated differs between the functions delegated:

- **Policy initiation**: Member states retain considerable control over the Commission's right to initiate policy, even under the "new approach". Fundamentally, since its inception in the late 1970s the priorities set by the European Council (comprising heads of states) exert significant influence on the Commission when setting its priorities. Moreover, the Commission consults member state officials when assessing what policy action to take and circulates proposals at the drafting stage to member states for comments. And naturally, Commission proposals cannot be adopted unless a majority of member states approve them.

- **Policy execution**: As for the Commission's powers to execute policy, by taking decisions that implement EU legislation, member states exert control primarily via the so-called comitology system. This system was created to ensure that member states retained control over the execution of common policies by the Commission. As a result, the Commission has to present draft proposals to committees composed of member state representatives before adopting them. Member states' degree of influence depends on the nature of the committee. Some committees are purely advisory. *Management committees* have the right to block proposals and refer them to the Council of Ministers. *Regulatory committees* must approve the proposals put forward by the Commission by qualified majority, or refer them to the Council.

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[14] This section builds on Tallberg (2002).

Overall, comitology allows member states to control the Commission's execution of common policies in a more continuous manner. In their quest to achieve an internal market for financial services, member states have delegated increasing powers to implementing committees in the area of securities markets, as will be illustrated further below.

- **Policy interpretation by the ECJ**: The ECJ is the most independent of the Community institutions. The little control that member states exert over the ECJ depends on whether the Court interprets Treaty rules or EU legislation. If the former, member states have no possibility to control and have to abide by the decision of the Court. If the latter, member states have the possibility to re-legislate, should they not share the Court's interpretation of a particular directive.

- **Policy enforcement**: The Commission is the "guardian of the Treaty" and accordingly member states cannot control the way it monitors member state compliance. The same goes for the ECJ's control of state compliance, where member states cannot reverse the Court's decision unless unanimously agreeing to change the Treaty.

In sum, while having delegated substantial powers to the Commission and the ECJ, member states retain methods of controlling the way these institutions initiate, execute, interpret and enforce policy.

Home Country Control

Underpinning mutual recognition is the principle of home country control, i.e. the member state where the goods or service provider has its seat is responsible for carrying out regulation and supervision of the entity. However, mutual recognition in general and home country control in particular require that regulatory authorities trust the standards and objectives of the other authority to be equivalent to the ones imposed in their jurisdiction. Host authorities, i.e. the authorities in other member states where the goods or service provider may offer its products, have frequently expressed doubts regarding this equivalence. As a consequence, it has often been difficult to harmonise regulation in the absence of granting host authorities at least some co-authority to supervise the activities of entities from other member states.

Enforcement of laws of the European Union

As outlined above, member states can decide to harmonise the way that they carry out certain policies, e.g. the way they regulate financial companies. Once such a harmonisation has been agreed upon, normally via the adoption of a directive, member states are obliged to (i) transpose the directive into national law and (ii) ensure that it is properly implemented and interpreted.

Ensuring Transposition – Infringement Procedures

The Commission, in its capacity as guardian of the Treaties, is together with the ECJ responsible for ensuring that EU laws are properly implemented and applied in member states (Article 226). Member states are liable for infringements of EU law. If the Commission finds that a member state has failed to fulfil its obligation it will launch a so-called "infringement procedure". First, it sends an official letter to the member state, where it outlines its reasons for considering that the member state infringes EU law and setting a deadline for the member state to comply. If this does not solve the dispute, the Commission or another member state (Article 227) may bring the case to the ECJ. The ECJ will then investigate the claim and decide whether the member state is indeed infringing the law. If it finds that this is the case, the member state is obliged to amend its legislation. If the member state fails to do so, the ECJ can impose a lump-sum fine or another form of penalty.

Ensuring Implementation and Even Interpretation – Temporary Rulings

Once transposed, member states must ensure that the law is properly implemented. In line with the fundamental principle underpinning the construction of the single market, the authority and responsibility to investigate, detect and prosecute breaches of Community law by regulated individuals or firms falls essentially on member states. In other words, national courts are also guardians of Community law, as the responsibility to review the administrative implementation of Community law rests upon member states' judicial systems. Therefore, if a regulatory authority or an aggrieved party considers that a regulated entity breaches a law, they must first use national courts. If national courts are in doubt how to interpret Community law, they may, and sometimes must, refer the matter to the European Court of Justice for a so-called "temporary ruling" (Art. 234). The ECJ then determines what the relevant Community law is. The national court must apply the law as interpreted by the Court without modifying or distorting it.

Supplementing the Enforcement Framework – the Lamfalussy Committee

The processes outlined above have been designed to ensure that (i) Community law is effectively transposed and implemented in member states and (ii) national courts do not interpret Community law differently. The Commission and the ECJ play key roles in upholding and interpreting Community law. While these processes look impressive on paper, there are a number of weak spots. First, often the Commission does not know that EU laws are being infringed. One reason is that private sector companies are hesitant to alert the Commission of such infringements, fearing that this may hamper their long-term relations with the infringing member states' authorities. Second, the processes are burdensome and timely, with infringement procedures and preliminary rulings taking several years from start to conclusion. These procedures are therefore not sufficiently efficient in deterring the undesired behaviour.

Enforcement of laws of the European Union (cont'd)

Lack of enforcement with respect to transposition has been identified as a particular problem in EU financial regulation. Accordingly, the Lamfalussy Committee devoted extensive thought to the issue and a persistent theme in its recommendations is ways of improving the incentives for proper implementation of EU law. First, the Lamfalussy procedure (see below) accords much more weight to peer pressure among member states. As securities regulators will meet much more often in CESR, the idea is that regulators not properly implementing law will have a much harder time justifying themselves to their peers. More direct political pressure will then be exerted on infringing member states in the European Securities Committee and Council of Ministers. Moreover, the Lamfalussy procedure explicitly refers to the importance of Commission enforcement, and has designated is as "level 4" in its four-level legislative process. Finally, an Inter-Institutional Monitoring Group was set up by the Lamfalussy Committee, which is charged with examining whether the recommendations of the Lamfalussy Committee are being properly enacted. However, as the Lamfalussy Committee operated under the limit of only proposing reforms within the confines of the current treaty, these reforms do not address the problems associated with the processes outlined above.

Source: "The ABC of Community Law", European Commission (2000).

A Large Role for the Member States

Under the single market approach, four elements affect the relation between member states and the centre. First, the primary legal measure used has been *directives* rather than *regulations*. Both measures have precedence over member state laws. However, while a regulation has direct effect, a directive offers member states the ability to choose the means by which they are to ensure meeting the ends set by the directive. Hence, a directive offers member states the ability to shape common laws to their circumstances as long as they fulfil the underlying aims.

Second, as a consequence of regulating by directives, member states are responsible for transposing EU law into national law, implementing these laws in a way that fulfils the aims set by the EU law and enforce the law in such a way that the law has the same effect in all member states.

Third, as a result of its minimal characteristic, laws under the new approach grant member states the ability to set higher standards, provided that they do not discriminate, i.e. restrict access from entities in member states that are satisfied with implementing the minimum standard set by the directive.

Fourth, as long as EU law does not exist in a certain area and as long as member states respect the straightjacket set by the Treaty in terms of non-discrimination, member states are free to add additional legislation.[15]

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[15] Accordingly member states are for example free to regulate hedge funds, as long as this legislation takes into account existing legislation regarding e.g. capital standards, investor relations, disclosure requirements etc.

(e) *Single Market Financial Services Directives*

As regards financial services, the White Paper contained a number of legal measures aimed at constructing an integrated European financial market place. Of these, some deserve particular mention[16]:

- **Institutions**: the 2nd Banking Directive (1989), the Investment Services Directive (ISD, 1993) and the third Life and Non-Life Insurance directives (1992) provide financial institutions (banks, investment firms, regulated markets and insurance companies) the right to present their services across the EU with a single licence, after notifying their home authorities of their intentions.

- **Instruments**: a 1985 directive enables fund managers to provide certain investment funds, collective investment undertakings or UCITS, across the EU. The 1989 prospectus & initial public offerings directives offered some basic harmonisation of the information firms have to provide when offering securities to the public, hence allowing firms to raise capital EU wide.

- **Solvency**: the 1989 Solvency Ratios directive harmonises the capital standards for banks in the EU, implementing the Basel Accord. The 1993 Capital Adequacy directive set minimum capital standards for banks' trading books and investment firms.

The importance of these directives is that they define the key ingredients (minimal harmonisation) that are required of institutions or instruments for mutual recognition to work. In the financial services sector, minimal harmonisation covers initial capital, solvency requirements, permissible activities, governance and supervisory requirements. These minimal standards do not stop member states from setting higher standards for institutions or instruments within their jurisdiction, but this does not allow them to ban institutions and instruments from other member states from providing services within their territory, as long as they meet the EU standard. The directives thereby prescribe a specific procedure which needs to be followed for this "single passport" system to work. When financial services are provided on a cross-border basis in the EU, the financial institution concerned is requested to inform its home country authorities of its intentions. The latter need to inform the host country authorities of the intentions of the institutions which fall under its supervision (the notification procedure). Host country authorities have time to respond, and to raise objections, but free provision of services is, when the procedure has been correctly followed, in principle automatic. However, the notification procedure has given rise to an extensive legal debate on the scope and length of the notification, and the possibility for exemptions. It has led the European Commission to publish an interpretative Communication in 1997 on the application of the notification procedure and the remaining host country powers in banking.[17]

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[16] See Gros and Lannoo (2000) for further details.

[17] Commission Interpretative Communication on the Freedom to Provide Services and the Interest of The General Good in the Second Banking Directive, SEC(97) 1193 final, Brussels, 20.06.1997.

3. Achieving a Truly Integrated Market for Financial Services

When the EU's member states in 1987 enacted the European Single Act the goal was to create a single European market where goods, services, capital and labour could move freely. By and large, this was achieved in time for the 1992 deadline, and an EU-regulatory framework for securities markets and financial services was in place. Nevertheless, this framework was not as developed in the different areas of financial services and obstacles to the provision of cross-border financial services remained. This was particularly the case for the area of securities markets, an area in which the experience of the EU member states was limited.

(a) *Shortcomings of the Single Market Approach*

The single market approach has succeeded in creating a single market for service providers, who can provide banking, insurance and investment services all over the EU under a single licence. But not all areas are equally integrated. Sometimes the lack of integration is related to cultural or historical preferences, e.g. differences between Britain and Germany in the choice of preferred channel of intermediation (market vs. bank finance). In addition, the market structure is not always optimal, e.g. in clearing and settlement, which increases the cost of cross-border trading. Legal traditions, moreover, differ between member states (e.g. approach to collateral and bankruptcy regimes) and member states sometimes restrict financial services actors, e.g. regarding the asset choice of pension funds, which also affects the integration of markets. Tax differences also play a major role in creating obstacles to integration.

But regulatory obstacles also explain the lack of integration. In certain areas, EU level legislation is missing. In other areas, legislation is in place, but is vague and leaves too much discretion to member states in implementation, has not been properly transposed or the Commission has been slow in enforcing it. In other areas legislation is on the other hand too detailed, and as financial markets constantly evolve, legislation is therefore rapidly outdated. In general, the EU's slow legislative procedure, where it normally takes three years for a legislative proposal to be adopted, is ill adapted to the fast-moving financial markets.

These problems have been particularly severe in securities markets. For a long time, insufficient regulatory harmonisation hampered the development of an integrated European capital markets. It provided the opportunity for member states to indicate that this or another area was not harmonised at the EU level, and that it was entitled to obstruct the free provision of services. Unlike the area of banking, the European Commission was rather lax on enforcement of harmonization requirements and lacked the experience of dealing with these matters.[18] This was a reflection of the fact that securities markets were until recently largely state-controlled in many member states, and that the emergence of a securities market worth this name was a recent phenomenon.

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[18] The jury is still out whether substantial benefits were achieved as a result of the 1992 single market programme for the integration of securities markets. Some will refer to the intense competition among regulated EU securities markets, and the process of consolidation as a result of the Investment Services Directive (ISD). But others will refer to the many barriers to pan-European capital raising exercises, and the fragmentation of settlement systems, which increases costs for institutions and consumers.

The launch of the euro in 1999 added a sense of urgency to rectifying this situation, as the full gains from a single currency would not materialise until a fully integrated financial market was achieved. The EU therefore took two initiatives, one aimed at updating the regulation in place, the other at reforming the regulatory processes and structures governing the enactment of financial regulation at the EU level.

(b) ***Further Regulatory Harmonisation***

Since 1998, the EU has set the objective of achieving a more integrated internal market for financial services by proposing further harmonisation of laws previously conferred to the realms of mutual recognition as well as updating financial regulation and hence eliminating any regulatory obstacles to full capital markets integration.

This renewed focus has been partly motivated by the expected economic benefits from further market integration, although it is still unclear why a political consensus was achieved to focus on financial services as an area in need for further regulatory harmonisation, and not on e.g. direct taxation, another major obstacle to an integrated market. A recent study, contracted by the European Commission estimated that the dismantlement of all obstacles to a fully integrated European equity market would in the long run raise the EU's real GDP level by 1.1% (€130 billion in 2002 prices).[19] While such measurements are politically popular, they are fraught with methodological pitfalls, however. In addition, no attempt has been made to measure the extent to which the proposals put forward by the Commission effectively bring about an integrated financial market.

Composition of the Financial Services Action Plan (FSAP)

The EU's leaders, meeting in the Cardiff European Council in June 1998, asked the European Commission to develop a plan for correcting the regulatory problems mentioned above. The FSAP, adopted in May 1999, states that the EU's legislation has to be updated, widened and deepened, and the legislative process has to be speeded up. It proposes 42 legislative initiatives in four key areas:

1. **Wholesale finance**: the launch of the euro created far-reaching change in EU wholesale markets. 19 of the FSAP's proposals are concentrated in this area. The Commission has e.g. put forward a new proposal for the regulation of securities markets and broker/dealers (ISD II), a new market abuse and insider trading directive, an extended prospectus directive and a directive on regular and ad-hoc reporting requirements.

2. **Retail finance**: the Commission wants to create "open and secure" retail markets. The FSAP contains 9 measures in the retail area. One of the objectives is to create clear and transparent information and to define redress procedures in order to ensure a high level of consumer protection while avoiding opening the door to

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19 London Economics (2002) at v-vi. Apart from the London Economics study, the Commission has presented three other studies done by external researchers: CEPS (2002), CESF/University of Salerno (2001) and IVIE (2003).

protectionism. It wants to create laws that enable the development of new distribution channels such as distance selling, especially in e-commerce. Another initiative is to encourage the development of safe, effective and cheap payment systems for cross-border retail transfers.

3. **Supervision**: currently financial supervision is in the hands of national authorities, supplemented by EU-led common interpretation of regulatory provisions and ad-hoc supervisory co-operation. This might not be enough to ensure the stability and soundness of the EU's financial system, but there is no consensus on what additional measures would be required. As for securities, although the Commission does not rule out a European correspondent to the US Securities and Exchange Commission (SEC) it judges that such a move is premature. Instead the Commission is proposing a Securities Committee that would help the EU's institutions to develop and implement regulation. The Commission also proposes the development of prudential rules regarding conglomerates, tougher laws on money laundering and more active information exchange with third countries.

4. **Linked areas**: legislation in other areas, not directly linked with financial markets, nevertheless lead to distortions and hampers the development of a single capital market. Taxes on savings income vary between member states, and so do corporate taxes. Supplementary pensions are also unequally taxed. Differences in corporate governance rules, e.g. shareholders' rights, also differ between member states. This adds additional uncertainty to cross-border activity. The Commission has proposed to phase out harmful tax competition, to create a common approach to the taxation of savings income and has urged the member states to diminish the differences in corporate governance.

Current State of Progress

While initially slow, progress in adopting the measures has accelerated since 2002. At the time of writing, 36 of the FSAP-measures were completed.

Main pillars of the FSAP – Current state of play (July 2003)

Legislative measure	Status
European Company Statute	Adopted, October 2001
Money Laundering Directive	Adopted, November 2001
Directives on UCITS I and II (investment funds)	Adopted, January 2002
Regulation on International Accounting Standards (IAS)	Adopted, July 2002
Market Abuse Directive (MAD)	Adopted, January 2003
Directive on Occupational Pension Funds	Adopted, June 2003
Prospectuses Directive	Adopted, July 2003
Investment Services Directive (ISD)	First reading, September 2003
Transparency Directive	First reading, November 2003
Takeover Bids Directive	blocked in the EU Council
Capital Adequacy Directive	in consultation

Source: e.g. European Commission (2003a). *Progress on the FSAP: Annex*. February 2003.

By virtue of design, the FSAP with hindsight appears excessively back-loaded, with the most important and hence most contentious proposals, currently on the table. Of these, three deserve particular mentioning:

- **Investment Services Directive**: in late 2002, the Commission completed two years of consultation by releasing its proposal for a revised ISD, a key directive under the FSAP covering the regulation of exchanges and brokers. Compared to the 1993 directive, the new proposal contains a much more ambitious investor protection regime, with e.g. the introduction of a best execution principle and enforced conduct of business rules applicable to regulated individuals and organizations. In addition, the directive introduces a transparency regime aimed at preventing a more competitive market place from fragmenting into disconnected liquidity pools. The latter have led to a polarization of views concerning the appropriate level of transparency in the market place, with some observers (mainly regulated markets) claiming that a high level is necessary to avoid fragmentation while others (mainly investment firms) claiming that too high levels of transparency stifles competition and hurts liquidity provision. The Economic and Monetary Committee (ECON) of the EP has so far been unable to reach agreement on compromise amendments, and as a result the first reading has been delayed.

- **Takeover bids**: after nearly 20 years of efforts, the EU still has no law governing takeover bids, ensuring equality of access for cross-border take-overs. Labelled a "vital part" of the FSAP by the Commission, an earlier draft directive suffered defeat in the EP in 2001, with voting divided largely on national lines. After referring the drafting of a new regulatory strategy to a committee of high-level experts, the

Commission in October 2002 put an amended proposal on the table. The proposal aims at incorporating some of the EP's stated concerns (e.g. definition of equitable price, board neutrality and employee rights). However, discussions have been just as rampant as last time around, with Member States demanding the dismantlement of other countries' defences while protecting their own and the European Commission taking no coherent stance. Therefore, agreement still seems elusive, be it in the Council or EP. [20]

- **Capital adequacy**: for several years, the Basel Committee on Banking Supervision (BCBS) has been working on an update of the Basel Accord. The European Commission has vowed to implement the new Accord once it has been improved. However, a number remain outstanding. First, the BCBS proposal has been significantly criticised, with the treatment of operational risk and the issue of pro-cyclicality being the subject of particularly intense debate. Second, recently the United States signalled that it planned to implement only part of the accord and only for some banks. Third, due to European legal requirements, the new accord will not only apply to internationally active banks, which is the case for other jurisdictions, but to all credit institutions. This may harm the competitiveness of these institutions. For all these reasons, the adoption of a new capital adequacy directive (scheduled for 2004) is likely to be contentious.

Therefore, while well on track, the FSAP still faces significant challenges and it remains uncertain whether the self-imposed January 2005 deadline will hold. For that to be the case, the three major initiatives detailed above have to be adopted before the end of the current legislative mandate for the European Parliament, which effectively means by April 2004.[21] If that deadline is not respected, legislative initiatives risk being delayed by the process of incorporating 10 new members in the EU's institutions. The deadline is also challenged by the additional fact that the EU is currently equipping itself with new regulatory procedures in the field of financial services law. This is especially the case for the securities market legislative measures, where since February 2002 a new four level regulatory process is in place, the so-called Lamfalussy process.

(c) *Reviewing the Delegation of Regulatory and Supervisory Powers*

As mentioned above, financial regulation follows the single market approach, i.e. minimum harmonisation of key rules, mutual recognition of remaining rules and home country control. However, there have over the years been debates regarding the degree of minimal harmonisation. Another emerging debate concerns the appropriate location of regulatory and supervisory authorities, with calls for further centralisation at the EU level. Although such a centralisation remains significantly contested, the importance attached to implementing the FSAP in a timely manner has brought renewed attention to the importance of the structures governing the regulatory process.

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20 For a comprehensive overview of the issues related to the takeover bids exercise, see McCahery et al. (2003).

21 A conclusion stressed by the Inter-Institutional Monitoring Group (IIMG) in its May 2003 report.

The Lamfalussy Procedure

In July 2000 the French Presidency initiated the appointment of a Committee of Wise Men chaired by Alexandre Lamfalussy with the task of drafting proposals for improving the effectiveness of the EU's securities market regulatory process. In February 2001, the Wise Men proposed a new four-level legislative process, where significant powers are delegated to implementing committees. The four levels are defined as follows:

1. Broad framework principles for legislation (so-called level 1 legislation) are agreed at the EU level. The Commission, after consulting widely, makes a legislative proposal to the Council and the Parliament using co-decision procedures.[22] In order to speed up the adoption, existing fast-track procedures are used if possible. In addition the preferred instrument should be regulations, i.e. a legislative act that is binding in its entirety and directly applicable in all member states, rather than directives, which can take up to 18 months for national authorities to implement.

2. The detailed rules (so-called level 2 legislation) how to implement the principles are developed at the EU level via the use of so-called comitology procedures. Under this procedure, the Council delegates the power to execute EU legislation to the Commission. Representatives of the member states assist the Commission by participating in "comitology" committees. The European Parliament has little direct influence and is more an external supervisor.

3. Enhanced and strengthened co-operation and networking between national regulators ensures that implementation of Community law at member state level becomes more consistent (level 3).

4. More attention is devoted to the enforcement of Community law. This is essentially the task of the Commission, but member states and their regulators should enhance their co-operation as well (level 4).

These proposals were endorsed by the heads of state and government at the Stockholm European Council in March 2001, following a commitment by the European Commission to "avoid going against the predominant views which might emerge within the Council". After a delay of almost one year, caused by the dissatisfaction in the European Parliament about its limited role, a "solemn declaration" was made by Commission President Romano Prodi where the Commission pledged to "take the utmost account of the position of the European Parliament [...] - within the scope of the current institutional arrangements", and the European Parliament in February 2002 approved the new approach in return for a promise to review the situation in 2004.

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22 For an explanation of the co-decision procedure, see Annex 1.

Accordingly, framework principles are agreed under the normal legislative procedure, i.e. the Commission, after consulting widely, sends a legislative proposal to the EU Council and the EP acting under co-decision procedure (double reading). The first measures using this approach have been agreed upon in the meantime, i.e. the market abuse and prospectus directives, although work on the implementing measures is still ongoing.

Regarding level 2 implementing measures, the agreement led to the creation in June 2002 of two new implementing committees. First, the power to draft and approve implementing measures has been delegated to the European Securities Committee (ESC). The ESC, acts as a regulatory committee chaired by the Commission and consisting of high-level Member State officials (in accordance with comitology procedures laid down in 1999/468/EC). Second, the Committee of European Securities Regulators (CESR) is an independent advisory group, advising the Commission in its drafting of implementing measures, and acting as a point of consultation for market participants. CESR consists of senior representatives of national supervisory authorities, in some cases independent securities commissions, in others integrated financial services authorities.[23] It plays an instrumental role in supervisory co-operation, i.e. improving the common and uniform implementation of EU rules. CESR issues consultative papers for implementing measures for EU directives (for example for the market abuse and prospectus directives) and standards on issues which are not (yet) formally harmonised at the EU level, such as alternative trading systems or clearing and settlement systems.[24]

In order to improve the enforcement of EU rules, the Council set up a monitoring group, consisting of EU Council, Commission and EP representatives. The group released its first report in May 2003.[25]

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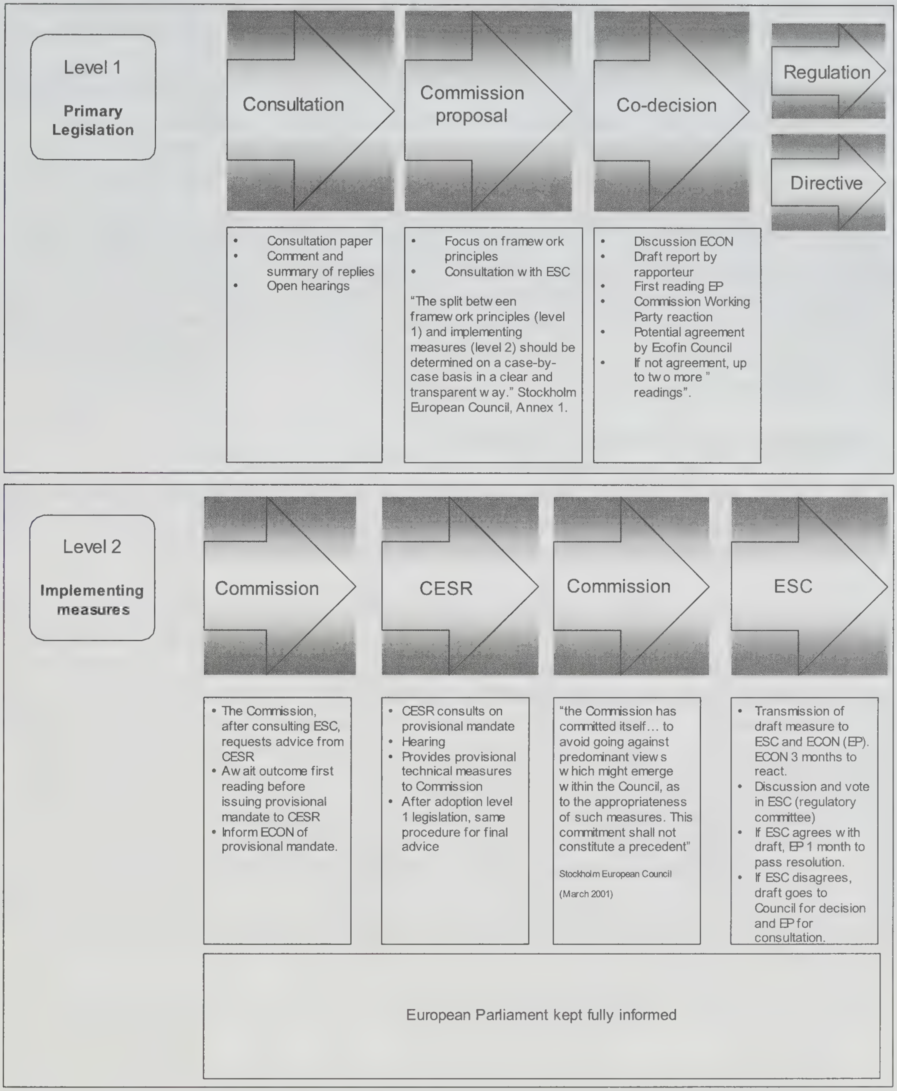
23 See Annex 2 for an overview of the supervisory authorities in the member states.

24 See www.europefesco.org for some examples.

25 Inter-Institutional Monitoring Group (2003).

The Lamfalussy Procedure – Level 1 and 2



Abbreviations:

- COM (European Commission)
- EP (European Parliament)
- ESC (European Securities Committee)
- CESR (Committee of European Securities Regulators)
- ECON (Economic and Monetary Committee)

Sources: Committee of Wise Men (2001), Inter-Institutional Monitoring Group (2003).

In sum, the changes to the regulatory structure following the Lamfalussy recommendations are primarily aimed at improving the efficiency of the legislative process. To accomplish that aim, the changes primarily imply a far-reaching delegation of regulatory power away from member states and the EP and in the direction of the European Commission, the institution which is in the driving seat under the comitology procedure. The Commission drafts the primary legislation, participates in CESR work regarding level three measures and advice on level 2 measures, drafts level 2 measures and chairs the meetings of the ESC. Nevertheless, member state authorities will have an important, if circumscribed, role. They maintain control in CESR, putting forward advice by unanimity. Moreover, they retain their regulatory role by voting (by qualified majority) on the draft implementing measures being put forward by the Commission. Therefore, the Lamfalussy procedure offers plenty of scope for member states to keep an imprint on future legislation. Nevertheless, the Commission's role has been enforced and it is now in sole capacity to set the legislative agenda. The main loser instead appears to be the European Parliament, which so far has no role once a framework directive has been adopted by co-decision.

Extension of the Lamfalussy Procedure

Since the inception of the Lamfalussy procedure for securities markets, there have been calls for applying the same format for all securities aspects (i.e. UCITS) as well as for the other parts of the EU's financial regulatory regime, i.e. banking and insurance.[26]

These calls were initially greeted with muted support from the European institutions, due to the very public disagreement over the adoption of the Lamfalussy procedure for securities markets. However, as a working agreement on how to apply the Lamfalussy procedure was reached between the Commission and the EP in February 2002, the possibility of extension has become more a question of timing. In the December 2002 meeting of EU economy and finance ministers Council, member states accepted the findings of the report by the Economic and Financial Committee (EFC), the main body charged with advising the Council, on financial regulation, supervision and stability.[27] In particular, the Council "reaffirmed its clear preference for implementing arrangements based upon the Lamfalussy framework to all financial sectors…". The Council also committed itself to work towards revising the rules that govern comitology in order to increase the role of the EP, i.e. revising Article 202 of the Treaty and the 1999 comitology decision. Pending agreement with the EP, the Council therefore endorsed the EFC's recommendations for a future regulatory structure:

- ***Securities (including UCITS)***: ESC regulatory committee and CESR advisory committee.

- ***Banking***: similar regulatory structure, i.e. a regulatory European Banking Committee (EBC) and an advisory Committee of European Banking Regulators (CEBR).

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[26] See for e.g. Lannoo and Levin (2003).

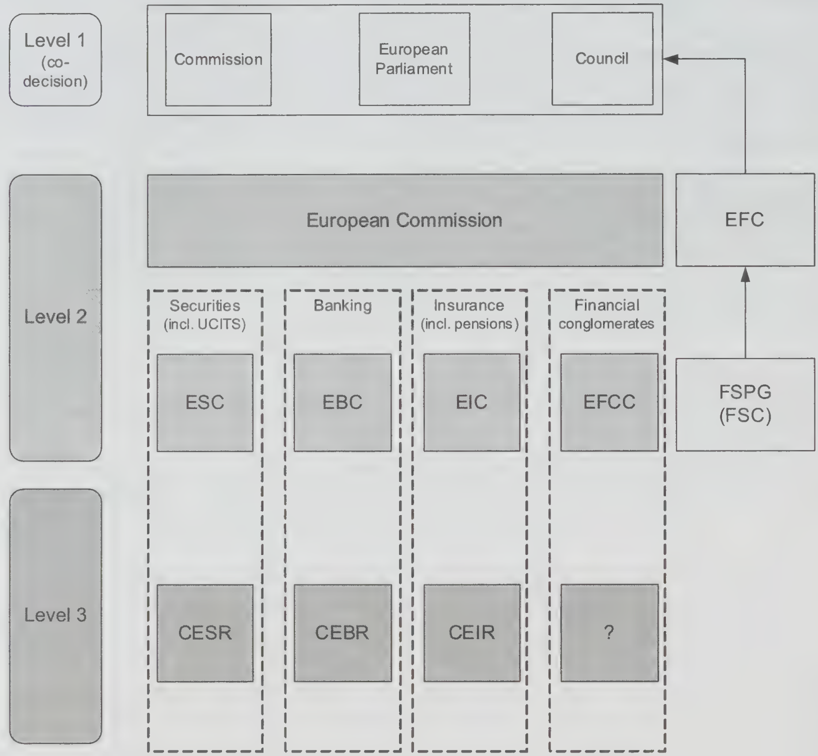
[27] Council (2002).

- ***Insurance (including pensions)***: one regulatory committee, the European Insurance Committee (EIC) and one advisory committee, the Committee of European Insurance Regulators (CEIR).

- ***Financial conglomerates***: in addition, the EFC recommends that particular attention be devoted to financial conglomerates and therefore proposes a similar comitology structure specifically devoted to those issues. It is less clear, however, on level 3 arrangements.

In addition, the EFC report proposed a new chain of command concerning policy advice to the Ecofin Council. The EFC will remain the primary source of advice on issues related to economic and financial affairs and financial stability issues to the Ecofin Council. It would be assisted by a new Financial Services Committee (FSC), which would replace the current Financial Services Policy Group (FSPG).

The New Regulatory Structure



Abbreviations:

ESC	European Securities Committee
EBC	European Banking Committee
EIC	European Insurance Committee
EFCC	European Financial Conglomerates Committee
CESR	Committee of European Securities Regulators
CEBR	Committee of European Banking Regulators
CEIR	Committee of European Insurance Regulators
EFC	Economic and Financial Committee
FSPG	Financial Services Policy Group
FSC	Financial Services Commission

Source: Ecofin Council Minutes, 3 December 2002, 14368/02 (Presse 361).

Once implemented, the EU will have taken yet another step towards a more centralised supervisory and regulatory structure. While there will be a plethora of committees in the short to medium term, the trends underlying this move to comitology are clear: a move towards granting the Commission a larger direct role in shaping detailed regulation at the expense of member state authorities, and an eventual unification of the fragmented committee landscape.

4. Issues Raised by Regulatory Reform and Market Integration

Thanks to the FSAP and the new regulatory structure, the EU is closer to its goal of achieving an internal market for financial services. However, the drafting, enactment and implementation of new laws and the new regulatory processes give rise to questions, some old and some new.

- Even though the EU has a new process in place, enacting legislation will remain difficult. The new structure will expose the lack of agreement on what kind of regulation the EU should be equipped with. For example, there is no agreement on the level of harmonisation required to achieve a truly integrated single market. Therefore, the EU should develop a European set of objectives and principles of good regulation.

- The raison-d'être for the Lamfalussy procedure was that it was regarded as a practical way of improving the EU's regulatory process within the confines of current Treaty powers. The result, however, is a complex regulatory system. In addition, before expanding the Lamfalussy procedure – by making it the norm for the enactment of EU financial regulation – it is necessary to solve the constitutional issues raised in the 2001 debate between the European Parliament and the Commission and Council. This gives rise to the difficult questions about the appropriate degree of centralisation. Any consolidation of comitology requires Treaty changes, notably regarding Article 202. Therefore, the European Convention and the forthcoming Inter-Governmental Conference (IGC) are key in the consolidation of the Lamfalussy procedure.

Overall, firm political commitment is needed for a single securities market to materialise. By approving the Lamfalussy committee's recommendations, the EU's member states have shown some of this. These points will be further elaborated upon below.

(a) *The Appropriate Degree of Harmonisation and Delegation*

The new regulatory procedure for securities markets poses the difficult question concerning the appropriate balance between level 1 (framework rules) and level 2 legislation (implementing measures), i.e. how much regulatory power should be delegated? Furthermore, by having a more flexible process at hand, the Commission may be tempted to press for further harmonisation of law. That puts the appropriate level of harmonisation on the agenda as well.

Harmonised Rules vs. Geographically Based Rules

The idea behind the FSAP was not only to update financial legislation in place, but also to bring about more harmonisation in order to enable further market integration. On this issue, market practitioners often take an incoherent stance. At the outset there was broad support for the FSAP among practitioners. However, as it has dawned upon them that more harmonised legislation not only comes with the benefit of opening up foreign markets to them, but also risks upsetting traditional regulatory approaches, support has become more qualified.

True, there is a genuine case for arguing that financial regulation in markets as diverse as the EU's financial markets cannot possibly be one-size-fits-all. Such differences may be structural. For example, the City's wholesale market functions differently from many other market centres, and legislation should accordingly try to accommodate to the extent possible the particular needs of this highly professional market place, but also those of other, less specialised markets. Such differences regularly give rise to arguments favouring less centralisation and granting more freedom to member states to set their own rules according to their circumstances and economic structures within their geographic boundaries.

This disparity is likely to persist, as it is a reflection of differences beyond the reach of current Community attention and powers (e.g. culture, taxation, overall legal approach). These persistent differences give rise to a difficult trade-off that Commission regulators have faced in the past and will increasingly face in the future: how to achieve further integration, which necessitates more harmonised regulation, while taking into account diversity and the needs this gives rise to.

By adopting the Lamfalussy Committee's proposals, member states and the Community institutions appear to have taken the decision that, by and large, the aim of achieving further integration takes precedence over adapting legislation to local needs:

- the new procedures is designed to make it easier to adopt harmonising framework laws (level 1);

- the new procedure also foresees more harmonisation of secondary legislation (level 2); and

- it is also likely to launch further convergence of rules via CESR's work on common standards and guidelines.

This decision should be read in the light of the single market experience outlined above. That approach relied upon minimal harmonisation, mutual recognition and home country control. However, outdated and ambiguous rules combined with too much discretion granted to member states in transposing the rules have contributed to a climate where policymakers have given primary status to the overall aim of achieving a single market. Therefore, while there are genuine concerns with pursuing full harmonisation, in the light of the deficiencies of the single market approach, EU leaders are leaning in the direction of stressing the dangers of insufficient harmonisation: uneven implementation and enforcement giving rise to persistent obstacles to further market integration. Therefore, the Lamfalussy approach has been adopted, as it is supposed to make the adoption of Community law easier and as it is supposed to provide more pressure on member states to apply Community laws in a proper and common manner.

(b) *Widening the Scope of Centralisation*

In order to solidify the gains made from the enactment of the Lamfalussy process for securities markets and in order to achieve its expansion to the other domains of financial regulation delineated above, agreement has to be reached with the European Parliament concerning its powers under comitology. Different points of view on the appropriate distribution

of power between the Commission, the Council and the European Parliament held up the adoption of the Lamfalussy findings between 2001 and 2002. In short, the Parliament resents the limited influence it has under current rules regarding delegation of power to implementing committees (it only has the right to be consulted). Instead, it has argued for the right to call back such draft implementing measures that it considers exceeds the implementing powers granted to the committees in the framework law (level 1). Unsurprisingly, granting the Parliament such a right was resented by member states. It was not until all agreed to refer the matter to a forthcoming round of Treaty revisions that a temporary agreement was reached in February 2002, hence permitting the adoption of the Lamfalussy procedure.

In light of the Convention's conclusions, it seems a foregone conclusion that the EP will receive its "call-back" and that the comitology decision will be amended to reflect this new reality. If adopted by the IGC, this would be in line with the institutional wishes expressed during the adoption of the Lamfalussy procedure for securities market law in February 2002.

If so, it will be a moment of truth for the European Parliament. Long regarded as a political dwarf, the EP has since the beginning of the 1990s been conferred the right to co-decide on an increasing number of dossiers. With a "call–back" it would in practice retain considerable influence over technical financial regulation. To perform that role adequately requires the EP to possess significant competence and expertise. Currently, that is not sufficiently the case. Compared to other legislative assemblies, the EP remains short on competent policy staff supporting Parliamentarians in their assessment of legislative proposals. Even though the Committee on Economic and Monetary Affairs (ECON) has increased its research staff by a hand-full and has appointed a panel of independent financial services experts, the situation remains precarious. If it is not corrected, and the EP as a result is not in a position to exercise its new found powers with diligence, legislation risks being held up.

(c) *Enhancing the Centre's Scrutiny of Member States*

One of the key outstanding problems with current EU law is uneven implementation and lack of enforcement of implementation and interpretation of harmonized requirements. The Lamfalussy Committee highlighted this issue and granted CESR an important role in increasing the convergence of regulatory approaches to common problems. As delineated above, CESR can carry out that task indirectly by bringing regulators together in regular meetings drafting advice for implementing measures, or more directly by drafting guidelines or standards.

The role of CESR in this respect is hard to overestimate, as effective international cooperation often starts by bringing different regulators together on a more formal and regular basis. By bringing different regulators together, best practices are likely to disseminate faster. Therefore, it could trigger a process of member states converging their supervisory practices and finally also regulatory structures. Currently, certain member states have a single supervisor (e.g. the UK), while others are divided according to the different financial services sectors

(e.g. Spain). Fewer and more similar regulators would facilitate the task of European supervisory cooperation and CESR.[28]

In the longer run, it is likely that to make the convergence process more effective, CESR guidelines and standards will have to yield more legislative force than is currently the case. These are only recommendations, even though member regulators have pledged to implement them.

5. Conclusion

The EU's single market is based on the principles of mutual recognition, minimal harmonisation of rules, and home country control. Over time, with the single market becoming more integrated, a process toward further harmonisation and centralisation has developed. This has led to call for more control over EU decision making, as well by the member states as by the European Parliament.

In the area of securities markets, and financial markets in general, an additional problem came into play, i.e. developing a system by which legislation can be adapted rapidly to market developments, while respecting the fundamental principles of democratic institutions and the EU. This was solved in the approach proposed by the Lamfalussy Committee, where the EU should enact laws reflecting general principles of regulation, whereas details are left to implementing committees.

It is too early to affirm whether this approach has worked, but it has generated political acceptance and is spreading to other areas of market regulation. However, some problems can be noted, and are likely to remain on the agenda for some time, the problem of settling what is principle and what is detail in regulation, the tendency towards further centralisation of regulation and supervision, and the interaction of democratic accountability and decision-making efficiency. For the EU's financial markets to continue to grow successfully, a balance will need to be struck between the strength of the centre and dynamism of its composing entities. So far, the consensus has allowed further strengthening of the centre, although the EU institutions need to check continuously whether the processes develop in line with the market's needs. Too high a degree of centralisation may undermine the strength of the EU's diversity, it may develop the EU away from its composing entities, and undermine the reason of its existence in the long run. Too much decentralisation will weaken the internal market, reduce the consensus behind the objectives and relegate the EU to a simple free trade area.

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[28] A point made by e.g. Sir Howard Davies, outgoing chairman of the UK Financial Services Authority (FSA), in a speech at the 2003 Belgian Financial Forum. An overview of the structure of the national financial supervisory authorities is given in Annex 2.

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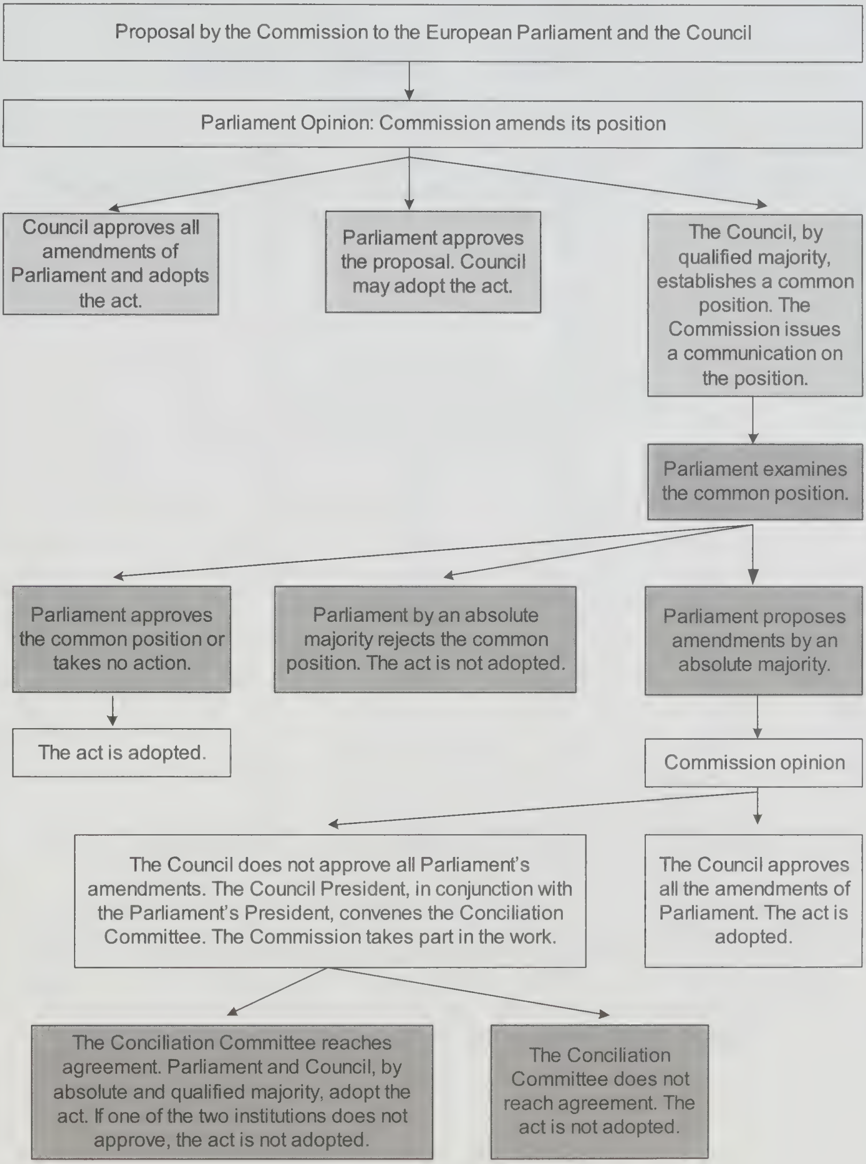
Annex 1
The EU's Co-decision Procedure



Source: "How the European Union Works", European Commission (June 2003).

Annex 2
Structure of the Financial Supervisory Authorities in the EU, Some Accession Countries, Japan and the US

	Banking	Securities Markets	Insurance
B	CB	CB	I
DK	FSA	FSA	FSA
DE	FSA	FSA	FSA
EL	CB	S	I
E	CB	S	I
F	B/CB	S	I
I	CB	S	I
IRL	CB	CB	G
L	BS	BS	I
NL	CB	S	I
AU	FSA	FSA	FSA
P	CB	S	I
SF	BS	BS	I
SW	FSA	FSA	FSA
UK	FSA	FSA	FSA
CH	BS	BS	I
CZ	CB	SI	SI
H	FSA	FSA	FSA
N	FSA	FSA	FSA
PL	CB	S	I
SLOE	CB	S	G
USA	B/CB	S	I
J	FSA	FSA	FSA

Notes: CB = Central Bank, BS = banking and securities supervisor, FSA = single financial supervisory authority, B = specialised banking supervisor, S = specialised securities supervisor, I = specialised insurance supervisor, SI = specialised securities and insurance supervisor, G= government department. The supervision of securities markets is a generalisation of the most prevalent model in a certain state; it does not take the spread of the elements of supervision over different authorities into account.

Source: Lannoo (2002).

The Impact of Federalising Securities Regulation in Australia: A View from the Periphery

Research Study Prepared for the
Wise Persons' Committee

Ralph Simmonds
Ray da Silva Rosa

October 6, 2003

**The Impact of Federalising Securities Regulation in Australia:
A View from the Periphery**

Biographies

Ralph Simmonds

Ralph Simmonds has law degrees from the Universities of Western Australia and of Toronto, and is admitted to practice in Western Australia and in Ontario. Between 1976 and 1979 he taught law at the University of Windsor, and between 1980 and 1989 he taught law at McGill University. In 1990 he returned to Australia to become Foundation Dean and Professor of Law at Murdoch University. In 1994/95 he served as the National Convenor of the Committee of Australian Law Deans, the peak body for all of Australia's law schools. He is currently Dean of the School of Law at Murdoch University.

Mr. Simmonds has his principal interests in, and has published books, articles, reports and shorter pieces on, corporations law and securities regulation, and on commercial law. He has consulted to both the private and public sectors, including, during his time in Canada, to the Ontario Securities Commission and the Commission des valeurs mobilières du Québec. He has also been involved in law reform in Canada and Australia, as well as the law of personal property, where he is the Chair of the Personal Property Security Reform Committee of the Australia / New Zealand Banking and Financial Services Law Association. He is currently the Chairman of the Law Reform Commission of Western Australia, which currently has as its major project a review of the recognition of Aboriginal customary law. He is also a member of the Executive Committee of the Corporate Law Teachers Association of Australia.

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Raymond da Silva Rosa (BCom, PhD) is an Associate Professor at UWA Business School, The University of Western Australia. He is the Director of the Research Centre in Accounting & Finance in the School and Director, Equities Research, of the Securities Industry Research Centre of Asia-Pacific (SIRCA), a financial services research organization based in Sydney. His research interests focus on the sharemarket consequences of M&As and the influence of ownership structure on corporate disclosures. Raymond has won Australian Research Council Large Grant support for his work in both areas. Significant research-based consultancy undertaken by Raymond include the capital gains tax accruing to the Australian Taxation Office of IPOs, a work for which confidential daily individual shareholding information was released by the Australian Stock Exchange, and modeling the likely impact of changes in takeover regulation for the Securities Institute of Australia.

The Impact of Federalising Securities Regulation in Australia: A View from the Periphery

Executive Summary

This Report recounts the Australian experience of national ("federal" or "federalised") regulation of securities markets under schemes for the regulation of companies and securities in place in that country between the late 1980s and the present day.

This Report focuses on how Australia provides an example of three different models of federal regulation. One model, the so-called Co-operative Scheme, is of federal rules and largely (but not entirely) localized regulation. Another model, associated in this Report with the early years of what it calls National Scheme Version 1, is of federal rules and regionalized regulation by a federal regulatory agency. The third model, particularly associated with what this Report calls National Scheme Version 2, although one that began to emerge under National Scheme Version 1 in its later years, is of federal rules and rather less regionalized regulation. This regulation is, however, by a federal regulatory agency that remains publicly committed to regional service delivery and regional input into policy-making.

This Report explains how Australia moved from one model to another, against a backdrop of concern for effective use of the resources for regulation, the maintenance of appropriate levels of service at the regional level and provision for regional input into policy-making at both the legislative and regulatory levels. This Report particularly focuses on the transition into and the experience of National Schemes Version 1 and Version 2.

This Report concludes that the Australian arrangements in the current model, under National Scheme Version 2, appear in Australian eyes to be a general success, if not necessarily to be optimal.[1] This is the view taken when an Australian observer regards these arrangements as about the maintenance, in a cost effective manner, of confidence in Australia's corporate sector and its capital markets. At the same time such an observer would be considering the extent to which the operators of that enterprise take account of regional interests and concerns and see to the delivery of appropriate levels of regulatory service throughout the regions of Australia.

This Report also goes into the nature of the capital markets in Australia, and the matter of the impact of National Schemes Version 1 and Version 2 on them. The Report concludes that, while the process of development of the models of securities regulation described in this Report has involved a highly complex and drawn-out legal process, the impact on Australian capital markets has not been correspondingly fraught. On the whole, the evidence is consistent with federalisation improving the efficiency of the Australian capital market. The national market has grown in size and the regional markets have not suffered in absolute terms.

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[1] The qualification for optimality is an important one, and is explained in note 193 below.

The Impact of Federalising Securities Regulation in Australia: A View from the Periphery

1. Introduction

This Report is for the Wise Persons' Committee of the Department of Finance Canada (the Committee).[2] The Committee's terms of reference call for it to make recommendations concerning the best model for securities regulation for Canada.[3]

This report addresses the experience in Australia of national securities regulation under a model of a single set of substantive laws, under a national regulatory agency. That experience falls into two phases.[4]

The first phase began with the move towards unified law and administration on the coming into force, on January 1, 1991, of the country's first arrangements for unified law and administration for companies and securities (National Scheme Version 1). National Scheme Version 1 rested on matching legislation in all six of the states and the Northern Territory to incorporate by reference legislation made by the Commonwealth for the Australian Capital Territory, and to confer power to administer the scheme on a regulatory agency established by the Commonwealth, which became known as the Australian Securities and Investments Commission (ASIC).

The first phase of the Australian experience ended with the coming into force, on July 15, 2001, of federal legislation to replace this combination of federal, state and territorial laws. This new federal legislation (National Scheme Version 2) was passed in exercise of power in that regard referred to the Commonwealth by the states under the reference power in the Commonwealth Constitution. It was designed to deal with significant constitutional infirmities that had been identified in respect of a number of aspects of National Scheme Version 1.

In particular, this report considers two questions:

1. what has been the impact of federalising securities regulation on the states and territories, in terms of control over regulatory policy and regulatory effectiveness, and

2. what has been the impact of federalising securities regulation on Australian capital markets – both during the transition period (the period of National Scheme Version 1) and during the post-implementation (the period thus far of National Scheme Version 2).

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2 From http://www.fin.gc.ca/wise-averties/main_e.html.

3 From http://www.fin.gc.ca/wise-averties/data/terms_e.html.

4 Which are explored in more detail in Section 5 of this Report.

This report considers these two questions particularly from the perspective of observers located in Western Australia (WA). WA is the state most remote from the financial and business centres of Australia, Sydney and Melbourne, which are respectively in New South Wales (NSW) and Victoria. As will be indicated, WA was initially resistant, but came to agree, to both National Schemes Version 1 and Version 2.

Sections 3 and 4 of this report outline the proposed research topics in somewhat more detail, and describe the methodology used. As noted, there are two research areas. One is the impact of the arrangements adopted in Australia in terms of control over regulatory policy and the effectiveness of the resultant regulation. The other topic area is the impact of those arrangements on Australia's capital markets.

Section 5 of this report provides an account of the political and legal history of the current Australian arrangements, by way of context to sections 6 and 7, which are the outcomes of the research.

Section 8 of this report is a conclusion on the Australian experience that highlights the features that may be of particular interest to a Canadian audience.

2. The First Research Area: Impact in Terms of Control Over Regulatory Policy and Regulatory Effectiveness

This area concerns how and why National Scheme Versions 1 and 2 came into being. Among other things, this requires the report to highlight the nature of the cases put up for the Schemes, and the political processes that led to their introduction.

This area requires the Report to draw a comparison of the impacts of the two Schemes, by reference to the following:

1. Development of new regulatory policy, particularly with respect to securities markets, in terms of their responsiveness to regulatory experience, changing market conditions and input from stakeholders, including regional stakeholders; and

2. Regulatory effectiveness, particularly with respect to securities markets, in terms of the effectiveness of their regulatory arrangements to meet their regulatory aims in the respects most closely corresponding with the objectives set for the

regulatory structure to be commended by the Committee,[5] namely, the aims set for the national regulator in Australia to[6]

(a) maintain, facilitate and improve the performance of the financial system and the entities within that system in the interests of commercial certainty, reducing business costs, and the efficiency and development of the economy; and

(b) promote the confident and informed participation of investors and consumers in the financial system; and

(d) administer the laws that confer functions and powers on it effectively and with a minimum of procedural requirements; …

The methodology for this area drew upon material from the literature relevant to these topics, particularly the legal, business, political and economic literature. The methodology also involved interviews with selected representatives from the Perth business, government, regulatory and legal communities.

3. The Second Research Area: Impact on Australian Capital Markets

This area requires the Report to address the effects of National Schemes Version 1 and Version 2 on the operations of Australia's primary and secondary capital markets and their financial services industries.

In particular, this area requires the Report to consider the effects on capital markets and their financial services industries of the introduction of National Scheme Version 1, of the developing sense that there were constitutional infirmities with certain aspects of it, and of the consequential movement that culminated in the introduction of National Scheme Version 2.

This area requires the Report to consider these matters so as to address the matter of effects on regional and local markets.

The methodology for this section incorporates qualitative assessments and quantitative measures of the impact of the National Schemes on the vitality of the WA capital market.

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5 From http://www.fin.gc.ca/wise-averties/data/terms_e.html (accessed June 8, 2003):

The objectives of the regulatory structure proposed by the Committee should be to:

- provide sound protection for investors and confidence that Canada's capital markets are regulated with the highest standards and that those standards are rigorously and equally enforced throughout the country;
- provide efficient capital markets for Canadian businesses of all sizes, and not place an undue burden on firms seeking to raise capital or on firms seeking to offer capital market services;
- encourage dynamic and innovative capital markets throughout Canada; and
- present foreign investors, governments and regulators with a positive image of securities regulation in Canada.

6 These are what the ASIC must "strive" to do in performing its statutory functions and exercising its statutory powers, under *Australian Securities & Investments Commission Act 2001* (Cth), s 1 (2) (from http://scaleplus.law.gov.au/html/pasteact/3/3449/0/PA000060.htm). Note that there is no paragraph 1 (2).(c) in the *Act*.

The qualitative assessments draw on interviews with prominent Western Australian-financial industry professionals and business persons who were asked to: (a) comment on the perceived relevance of the National Schemes to WA-based capital market participants, (b) supply instances that illustrate the impact (positive or negative) of the National Schemes on capital market activity in WA, (c) advise whether due consideration had been paid to local market conditions in the drafting and administration of the National Schemes, and (d) make predictions about future developments in securities legislation and how they will affect the WA capital market.

Another source of qualitative data consists of media commentary on the National Schemes. Commentary in the financial media may be used as an indication of the perceived importance and relevance of legislation. Just prior to the introduction of National Scheme Version 2, the *Hughes* decision[7] posed a legal challenge to federalisation of securities' legislation. The important aspect of *Hughes* decision from the Report's perspective is that it provided a well defined threat to the certainty of legislation and so reviewing the media attention to the case can show how Australian capital markets coped with the uncertainty during the transition period to National Scheme Version Two.

The quantitative assessment of the National Schemes' impact on the WA and national capital markets is based on the well-known "event-study" approach: an investigation of the impact of an ostensibly significant event on agreed measures of performance. It is usual in event studies to control for other factors likely to affect performance. This is not possible in the present case since federalisation affected all capital markets in Australia and so a "control" sample is unavailable for comparison. Reviewing changes in the following measures before and after the introduction of the National Schemes can indicate how well the WA capital market has survived. The measures are compared against the same measures for the other more populous states (NSW and Victoria) to see if WA performed poorly or better.

The hypotheses to be tested are the expectations that the reforms have had an impact on the following measures (investigated by reviewing trends over time):

1. No of WA-based companies

2. Concentration of WA-based companies across industries (it might be expected that this reflects regional specialisation)

3. Performance of WA-based companies since federalisation

4. Share market participation by WA-based investors

This section will address the effects of National Schemes Version 1 and Version 2 on the operations of Australia's primary and secondary capital markets and their financial services industries.

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7 For citations, see note 51 below.

4. The Context to the Australian Arrangements: A Political and Legal History of National Schemes Version 1 and Version 2

One of the Report's authors recently presented an account of the Schemes, primarily as a legal history, for a conference for a Canadian audience. Another Australian observer, a past Chairman of ASIC, prepared a similar account for the same conference, but from a more political point of view. This account draws heavily on these two accounts, while emphasising the WA perspective at a number of points.[8]

This account is to enable the reader of this Report to understand the accounts of the impacts of the National Scheme arrangements in Sections 6 and 7.

(a) *The Period Prior to the Call for National Scheme Version 1 – Herein Particularly of the Co-operative Scheme Era*

The period here is that from Federation (in 1901) to the mid-1980s, and in particular the period from 1981 of what is known as the "Co-operative Scheme".[9]

In the Australian federation, the starting point for analysis of the power of regulation in relation to securities is seen to be the general power to incorporate companies. The traditional view, confirmed by the 1990 *Incorporation Case,*[10] was that it lay with the states, not with the Commonwealth, notwithstanding the head of power making express provisions for most corporations in the *Australian Constitution*, section 51 (xx).[11] This gave Australia relatively uncoordinated state corporations statutes that included some elements of what North Americans would call securities regulation, most notably the regulation of primary market transactions. This state of affairs continued until the late 1950s, when Australia's post-war prosperity renewed calls, dating back to the pre-Federation era,[12] for uniform or at least harmonised corporation law.

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8 See papers by Ralph Simmonds, "Australia's Transition to a National Corporations and Financial Products Regulator: Lessons for Canada?", and Alan Cameron, "Keynote Lunchtime Presentation", for A Symposium on Canadian Securities Regulation: Harmonization or Nationalization?, Toronto, March 8, 2002 (http://www.rotman.utoronto.ca/cmi/news/march8_index.htm). See also on those and the other papers for the Symposium, A. Douglas Harris, "White Paper", available from the Capital Markets Institute of the University of Toronto; and for a further published discussion of the papers from a Canadian standpoint, see A. Douglas Harris, "Securities Regulatory Structure in Canada: the Way Forward" (2003) 38 *Canadian Business Law Journal* 57, esp. at 121-122.

9 For an account focusing on the *pre*-Federation (or "colonial") period, as well as the first few decades after Federation, see Rob McQueen, "Limited Liability Company Legislation – the Australian Experience" (1991) 1 Australian J. of Corps. L. 22.

10 *New South Wales v The Commonwealth* (1990) 169 CLR 482.

11 *Australian Constitution*, s 51 (xx): "The [Commonwealth] Parliament shall, subject to this Constitution, have power to make laws for the peace, order and good government of the Commonwealth with respect to … (xx) Foreign corporations, and trading or financial corporations formed within the limits of the Commonwealth: …"

12 See Roman Tomasic et al., *Corporations Law in Australia*, 2nd ed. (2002) at 17.

The calls were particularly based on the perceived difficulties for national businesses caused by differences in the rules and their administration. The degree of disharmony of the state laws by that time was, notwithstanding much common borrowing from UK legislative models, and from one another, quite significant. It even extended to the mechanisms for recognition of out-of-state entities.[13] Just as variant were the approaches to the administration of those laws.[14]

Following an agreement between the states and with the Commonwealth, the early 1960s gave Australia the so-called Uniform Companies Acts across the states. These included,[15] from prior law, controls of a securities regulation sort, of primary market transactions and of the regulation of the offering by companies of interests in non-corporate ventures.[16] This legislation also included the first discrete take-over bid regulation.[17] These Uniform Acts were initially very similar, but they soon began to drift apart. However, there was no similar attempt at uniformity in administration.[18]

Something of the history of the uniform corporations legislation was repeated in the early 1970s, when for the first time the matter of the regulation of securities markets as a discrete focus for legislation came to prominence. This prominence was the result of an extraordinary boom and bust cycle in the stock markets in securities of mining companies, particularly ones based in WA. Most of the states enacted uniform legislation to regulate stock markets and securities intermediaries and to outlaw certain forms of market misconduct, although there were significant differences between the "uniform" acts. And there was no parallel attempt at uniform administration.[19]

At the federal level, there had been serious consideration of federal corporations law in the early 1930s, although nothing came of it then.[20] However, in the early 1970s the same market conditions that produced the "uniform" securities industry legislation attracted the attention of the federal parliament and led to a major inquiry into the securities industry. An epochal change in government to a federal Labor one, and a relatively expansive judicial re-interpretation of the federal corporations power,[21] resulted in the introduction of the federal Corporations and Securities Industry Bill of 1974. This bill was, broadly speaking, *federal* securities regulation. It provided for federal regulation of fundraising and of periodic disclosure, by certain sorts of the corporations, being ones to which federal legislative power was thought to extend. There was also to be federal regulation of offerings by these federal corporations of interests in non-corporate ventures, of the operations of securities markets and securities

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13 *Ibid* at 20.

14 *Ibid* at 19 (citing research showing different degrees of 'stringency' in regulation across the states).

15 See e.g. *Companies Act* 1961-1975 (WA), Part IV "Shares, Debentures and Charges" Div 1 "Prospectuses" and Div 5 "Interests other than shares, debentures, etc", and Part VIB "Take-overs".

16 On the history of the regulation of these interests that came to be called "prescribed interests", see H.A.J. Ford, *Principles of Company Law*, 4th ed. (1986), paras. [1322], [1323].

17 See P. Little, *Law of Company Takeovers* (1997) at 15.

18 See Tomasic et al., 2nd ed., *supra* note 12 at 21.

19 *Ibid* at 21.

20 *Ibid* at 20.

21 By *Strickland v Rocla Concrete Pipes Ltd* (1971) 124 CLR 468, in Tomasic et al., 2nd ed., *supra* note 12 at 22.

intermediaries, and of take-overs. The Bill did not, however, provide for the traditional company law topics of the incorporation of companies, or of such matters as relations between companies and their directors and officers, or between companies and their members.[22]

While the dismissal and subsequent electoral defeat of the federal Labor government meant the *Corporations and Securities Industries Bill* of 1974 was never enacted, the conditions that led to the *Bill*, together with the continuing call for greater harmony in Australian company and securities law and its administration, also produced the first major move to coordinated *state* legislation *and administration*. This was in the form of the agreement of three states to establish an Interstate Corporate Affairs Commission (ICAC) in 1975, and greater harmonisation of their respective corporate and securities industry laws.[23]

At the same time, there was a continuation of federal interest in uniform law and administration, if not in the Labor solution of federal law. The result was the immediate precursor of the National Scheme Version 1, the Co-operative Scheme. It left to the states the revenue stream from incorporations and related formalities, a matter of concern to them.[24] But it provided for a fairly simple solution to the problem of the drift in uniform laws that had characterised earlier responses to these conditions. That solution was the enactment of model Commonwealth legislation, under its plenary power to make law for Commonwealth territories. This initially included separate companies, securities industry, and take-over legislation, and was followed some years later by legislation for the emerging futures industry.[25] This legislation was in turn incorporated into state law by reference made in complementary state Acts.[26]

The Co-operative Scheme also provided for the establishment of a national regulator, the National Companies and Securities Commission (the NCSC), although it was required as much as possible to, and did, delegate its powers to the state administrative bodies, by then called Corporate Affairs Commissions (CACs). These were responsible to the NCSC for their administration under the Scheme. Overseeing the Scheme was a Ministerial Council for Companies and Securities (MINCO), established like the ICAC by agreement, although this time between all of the states and the Commonwealth. MINCO had to approve any amendments to the applied Commonwealth legislation.[27]

(b) *The Call for What Became National Scheme Version 1, and the Response*

The immediate political backdrop to the Scheme is usually located in what is known in Australia as the "excesses of the 1980s", and the perception of an inadequate response to them under the Co-operative Scheme just described.

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22 See Tomasic et al., 2nd ed., *supra* note 12 at 22.

23 *Ibid* at 22-23.

24 *Ibid* at 23.

25 *Ibid* at 23 (laws for the Australian Capital Territory, in which the national capital Canberra is located).

26 *Ibid* at 23 (also included in this scheme and the successor National Scheme was the Northern Territory).

27 *Ibid* at 23-24.

The flavour of the perceived "excesses of the 1980s" is captured in the following quotation from a popular account of them[28]:

> The corporate booms and busts of the 1980s were the greatest ever seen in Australian history. The boom saw a bunch of corporate cowboys financed to dizzy heights by greedy and reckless bankers. Large sectors of Australian industry changed hands. Ownership of the major brewing and media companies changed completely. …Alan Bond [a WA entrepreneur] built an enormous empire on debt and creative accounting.
>
> The ensuing bust saw awesome destruction. The collapses included Australia's largest industrial group (Adelaide Steamship); the ninth largest enterprise in the nation, measured by revenue (Bond Corporation); nearly half the brewing industry (Bond Brewing); all three major commercial television networks (Bond Media, Qintex, Channel Ten); Australia's largest car renter (Budget); the second largest newspaper group (Fairfax); Victoria's largest building society (Pyramid); and Australia's largest textile group (Linter). Severe problems were faced by Australia's largest company, as measured by revenue (Elders), its largest media group (News) and the other half of the brewing industry (Fosters). …
>
> The devastation was equally great among the financiers. Total write-offs and provisions by banks and financiers amounted to $28 billion. Australia's three largest merchant banks (Tricontinental, Partnership Pacific and Elders Finance) had to be rescued by their parents. Two of Australia's four state banks (State Bank of Victoria and State Bank of South Australia) suffered devastating losses and were investigated by Royal Commissions. [One of those] (the SBV) was taken over by the Commonwealth Bank. The other two state banks, the Rural & Industries Bank of Western Australia and the State Bank of New South Wales, were deeply scarred. The four major trading banks (Westpac, National, Commonwealth and ANZ) had to write billions of dollars off their loan books, the suffering being particularly heavy in Westpac and ANZ. The losses of foreign banks operating in Australia were even higher proportionately, some of the worst being those of Hongkong Bank Australia, Standard Chartered, Security Pacific and Bank of New Zealand.
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> At the end, investors were left excoriating corporate cowboys such as Alan Bond, Christopher Skase and Laurie Connell [another WA entrepreneur]. While these and other men deserved blame, it should have been spread more widely. Australia, after all, is no stranger to corporate cowboys. The country has had them in almost every decade of its existence. What was truly abnormal about the 1980s was the extent to which they were able to lay their hands on money. Never before in Australian history has so much money been channelled by so many people incompetent to lend it into the hands of so many people incompetent to manage it.

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[28] Trevor Sykes, *The Bold Riders* (Melbourne: Allen and Unwin, 1996) at 1, quoted in Cameron, *supra* note 8 at para. 2.1.

> The banks financed the takeover of old, stodgily managed businesses by new, often unsound managements. Backed by debt from the banks the corporate cowboys drove up asset prices, in particular the prices of businesses, property and equities. The paper castles they built were increasingly vulnerable to any harsh wind. The first cyclone to blow came on October 20, 1987, when the world's share markets lost one-quarter of their value in a single trading session. An over relaxation of monetary policy then allowed a false boom to continue for more than another year, particularly in the property market too and plunged Australia into a recession.

The perception of the inadequacies of the Co-operative Scheme to deal with all of this principally rested on concerns about the lack of resources devoted by the states to the front-line regulators, the CACs,[29] as well as concerns about the lack of effective coordination between them (notwithstanding the "Co-operative" character of the scheme) in matters of investigation and enforcement.[30]

There was at the same time a perception of the considerable difficulty of deploying effective investigation and enforcement of *any* sort in relation to the misdoings of the time. This is captured in the following quotation from another popular account of the period[31]:

> Australia had itself to blame for what certain businessmen had been allowed to get away with, because its system of corporate regulation in the 1980's was pathetically inadequate. (I)t is worth considering the difficulties that face any society in combating or preventing corporate crime. It is probably true of almost anywhere that it is easier to steal $10 million from the shareholders of a public company than it is to take $1000 from a company's Christmas Club. It is probably also true of any country that the white-collar criminal is far less likely to be convicted and sent to jail than the petty thief. But it is certainly true of Australia. The way we treat the two offenders is salutary: if someone robs the Christmas Club and cannot pay the money back, the police will be called, the culprit will be taken away to be questioned, perhaps even put in the cells overnight. Prosecution and public disgrace will follow. The offender will almost certainly end up in jail and emerge to find his job has gone. But when a company director steals $10 million from his shareholders, if the corporate regulators find out about it at all, Mr Bigshot will be interviewed in his office, flanked by lawyers who are outraged on his behalf at the slur being cast on his name. He will probably say nothing, but his advisers will assure the investigators that the transactions are perfectly legal and have been approved by the top law firm in the country. It will then be the investigators' luckless task to prove them wrong. Even if they can gather the documentary evidence, they will be lucky to find a jury that can understand it and will convict. That is true almost anywhere in the world – corporate structures, clever lawyers and sheer complexity both protect and sanitise unacceptable conduct.

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29 See Cameron, *supra* note 8 at para. 2.2.

30 *Ibid* at paras. 3.3-3.5 (contrasting action able to be taken under National Scheme Version 1).

31 From Paul Barry, *The Rise and Fall of Alan Bond* (1990), as quoted in Cameron, *supra* note 8 at para. 2.2.

The considerable public criticism of the arrangements of the time that this produced, when combined with a federal Labor government that was committed to economic reform to improve Australia's international competitiveness and that was keen to assert a national role in economic regulation, led in 1987 to action on the call by the report of a federal parliamentary committee for "comprehensive [federal] legislation covering the field currently regulated by the co-operative scheme".[32]

This call rested on three bases.[33] One was that MINCO rendered ineffective the doctrine of ministerial accountability for the regulation of companies and the securities and futures industries. The second was that the regulatory complex of NCSC and CACs produced waste and duplication as well as under-funded regulation. And the third was that the whole scheme with its stress on unanimity created the conditions for regulation of the lowest common denominator sort, to the ultimate damage of investor confidence, including foreign investor confidence, in Australia's capital markets.

The action on this call was federal legislation, in 1989, providing for companies *as well as* securities and futures law, based on the Co-operative scheme legislation. This legislation was in the form of the *Corporations Act 1989* (Commonwealth), as well as a novel (for Australia) *Close Corporations Act 1989* (Commonwealth). This legislation was to be administered by federal regulatory bodies, principally the Australian Securities Commission (the ASC), as provided for by the *Australian Securities Commission Act 1989* (Commonwealth). The substantive legislation, apart from the *Close Corporations Act 1989*, was based fairly closely on the legislation under the Co-operative Scheme.

This unilateral move to regulate excited considerable although far from unanimous opposition across the legal, accounting, political and business communities in the states in Australia, but most particularly in regions remote from the country's major business centres of Sydney and Melbourne, such as WA with its capital Perth.[34] The opposition was rooted in

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32 Commonwealth Parliament, Standing Committee on Constitutional and Legal Affairs, *The Role of Parliament in Relation to the National Companies Scheme* (1987) at 74, quoted in Ralph Simmonds, "The Commonwealth Cannot Incorporate Under the Corporations Power: *New South Wales v The Commonwealth*" (1990) 20 Univ. West. Aust. L. Rev 641 at 644. This theme continues to be sounded throughout the development of both National Scheme Version 1 and later National Scheme Version 2. The authors would note, however, that there appears to be no quantitative empirical analysis that was assembled to support this case for either Version. At least none was published, and the authors were not made aware of any.

33 The summary here is from Simmonds (1990), *supra* note 32 at 644. There is relatively little literature in Australia on the case *for* state-based corporate (if not securities) law. For discussions, see Ian Ramsay, "Company law and the economics of federalism" (1990) 19 Fed. L. Rev. 169; Simmonds, *supra* note 32 at 652-653 (noting both market-based and legitimation-based arguments); and the work of the late Michael Whincop (see references in his "The National Scheme for Corporations and the Referral of Powers: A Sceptical View" (2001) 12 Public L, Rev. 263, especially that in note 107, below).

34 See e.g. the pamphlet "Companies and Securities Law [:] The Overwhelming Case Against a Federal Takeover", issued on behalf of such groups as the Law Society of Western Australia, the Western Australian Chamber of Commerce & Industry (Inc), the Institute of Directors in Australia (WA Branch), the Chamber of Mines of Western Australia (Inc) and the Stock Exchange Members in Perth, undated (1989?). This pamphlet had wide distribution in Perth.

concerns about loss of local influence over the formation of legislative and regulatory policy,[35] loss of local access to the decision-makers in the regulator, and costly deterioration in levels of local service from the regulator.[36]

A number of the states, most notably New South Wales, Western Australia and South Australia, challenged the constitutional validity of a range of provisions in these new arrangements. In the decision in the *Incorporation Case* in January 1990[37] the High Court held, probably to the surprise of most Australian lawyers who had taken a close interest in the matter,[38] that, among others, two sorts of provision could not be sustained under the Commonwealth's corporations power. One was the incorporation of companies by the ASC. The other was the prohibition of the formation of business associations with more than a stipulated number of members unless they were incorporated. The majority in the case was clear, and the reasoning fairly short. Most lawyers now take the matter as resolved.[39] Just how far the reasoning in the case extended, to invalidate *other* provisions in the Commonwealth legislation was and remains unclear, however.[40] But the case led to the repeal of all of the new federal legislation.

What was clear was the Commonwealth's continuing determination to achieve the vision of the 1987 parliamentary report, of single corporate, securities and futures law for Australia, under one national regulator. The determination appears to have rested heavily on concern about the national reputation of Australia's business and financial services communities in what was perceived to be an increasingly globalised market for investment capital. As will be seen this determination continued over the life of National Scheme Version 1, has been bipartisan, and appears to have led the Commonwealth to make some significant concessions to the states to gain National Scheme Version 2.

By the time of the move to National Scheme Version 1, the Commonwealth's determination had gained considerable support from the *national* financial press, in language that echoed that of the original call for national regulation from the federal parliamentary committee report of 1987,[41] and with support from a number of peak (*national*) business bodies, notably,

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35 See Ramsay (1990), *supra* note 33 at 172.

36 See source *supra* in note 34.

37 *New South Wales v The Commonwealth* (1990) 169 CLR 482.

38 Simmonds (1990), *supra* note 32 at 650.

39 This was also true of commentators at the time, although one of this Report's authors was an exception: see Simmonds (1990), *supra* note 32, *passim.*

40 Consider for example the matter of the fundraising controls: were they so closely related to the matter of incorporation as to be covered by the same reasoning? For a discussion, see Simmonds (1990), *supra* note 32 at and of 654n 60 (noting parallel Canadian question); compare the views in the article by Whincop (2001), *supra* note 33.

41 See e.g. Peter Gill, "Securities laws are seen as 'inadequate and confused", Australian Fin. Rev. (April 24, 1990) 4; "Divided we fall on company law", Australian Fin. Rev. (April 23, 1990) 16; Anne Davies, Bill Pheasant and Michael O'Meara, "Pressure to compromise on ASC", Australian Fin. Rev. (April 19, 1990); Peter Gill, "Slanging match continues in company law debate", Australian Fin. Rev. (April 9, 1990) 7; "Company law debate in sorry state", Australian Fin. Rev. (April 5,1990) 16.

the Business Council of Australia, the Australian Stock Exchange and the Merchant Bankers Association of Australia.[42] The federal Labor government went into a national election campaign promising action in this area.

Following its return to power, the federal Labor government indicated that it was prepared to proceed with a revised version of the unilateral legislation on which the High Court had ruled, excising those parts to do with incorporation, so as to leave those considered to be within Commonwealth legislative power. At least one state – Victoria – was prepared to go along with this,[43] while most of the others were prepared to go along also, but only to the extent of the provisions on securities and take-over markets, on the basis of the conceded importance of national regulation of those areas.[44]

In these circumstances there was considerable discussion among the states and territories and between them and the Commonwealth. The result was an agreement between almost all of them in mid-1990 on what became the first National Scheme. The initial hold-out was WA, whose Labor government expressed its concerns about levels of service in the state, both in operational matters (including document processing and investigations and enforcement) and influence over regulatory policy.[45]

By early December 1990, however, the state government's concerns had been neutralised. This neutralisation was the result, it seems, of the principal terms of the *Corporations Agreement*, which are rehearsed below. Those terms went to guarantees as to the establishment of Regional Offices of the national regulator, under Regional Commissioners; of local service levels at least the equal of those "formerly provided in the State [including the Northern Territory] in the course of local administration of co-operative scheme laws";[46] and the arrangements to compensate the states and the territory for the revenue stream they gained that was associated with the Co-operative Scheme.[47]

However, the Liberal (conservative) opposition in WA, which had a majority in the upper house of the state parliament, remained opposed, on the original grounds.[48] The opposition's position dissolved, however, in the face of concerns from the Perth broking community about the possible non-application to it of the National Guarantee Fund administered by the ASX if WA remained outside the proposed National Scheme.[49]

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42 See "Slanging match continues in company law debate", *supra* note 41.

43 See "Company law debate in a sorry state", *supra* note 41.

44 *Ibid*

45 See John Slee, "WA holds back on company scheme" *Sydney Morning Herald* (June 30, 1990) 7.

46 *Corporations Agreement* (1997), article 604 (1). For more on the *Agreement*, see below. This undertaking was backed up by reporting obligations, and gave rise to significant issues in the administration of the Scheme. On those reporting obligations, see below, text at note 58; on those difficulties, see below, paragraph at note 165.

47 This stream was significant: see on it, and the equivalent stream under the National Schemes Version 1 and Version 2, text at and following note 138, below.

48 See Tony Kay and Rowley Spiers, "Talks fail to break WA deadlock on company law", Australian Fin. Rev. (December 20, 1990) 3.

49 See Cameron, *supra* note 8, para. 2.5.

(c) *The National Scheme Version 1*

The legislative underpinnings of the National Scheme Version 1 were the original unilateral federal legislation, itself substantively based as has been seen on the legislative underpinnings of the Co-operative Scheme[50], but with modifications to allow for its new basis, and with administrative arrangements agreed with the states and the territory.

This Scheme was later to be judicially stigmatised as "so complex …, with fiction piled upon fiction that it must be doubted whether any of those presenting and enacting it were truly aware of precisely what they were doing".[51]

In fact, the Scheme was in large measure an extension of the logic of the earlier Co-operative Scheme, using the device of referentially incorporated Commonwealth legislation (based on the previous Commonwealth legislation) and a Ministerial Council for Corporations (MINCO) under the mid-1990 Heads of Agreement between the Commonwealth, the states and the Northern Territory. This Agreement was not in fact formally executed by the parties until 1997, as the *Corporations Agreement* (1997), because of continuing efforts by the states to improve its terms so far as their interests were concerned. But the basic principles from the Heads of Agreement were preserved in the final product.

Under the *Agreement*, and unlike the previous co-operative arrangements, there was exclusive Commonwealth control over, although state and territorial voice in, amendments to the applied Commonwealth law in relation to securities, futures, fundraising and takeovers. Also, amendments to the other, corporations law, provisions were possible by majority vote, in which the Commonwealth was given four votes and a casting vote and the other participants one each, and a Commonwealth veto on any proposal.[52] A single, federal regulator, the ASC[53], was provided for, appointments to which were to be made by the Commonwealth in consultation with MINCO.[54]

In the new National Scheme there was to be no role for state-based regulators. However, there were to be Business Centres (for document filing and similar purposes) in each state and territory capital, and, perhaps more importantly for regional sensibilities, Regional Offices in each state and territory, presided over by Regional Commissioners to whom the ASC was to delegate its functions and powers "to the fullest extent practicable, and having regard to issues of efficiency".[55] These Offices were established under arrangements that provided for the transfer

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50 See McQueen, *supra* note 9 at 43-44.

51 *R v Hughes* (2000) 18 ACLC 394, per Kirby J at 406 (High Court of Australia), quoted in Tomasic et al., 2nd ed., *supra* note 12 at 28. For a fuller set of citations to this case, see note 69, below.

52 See Simmonds (1990), *supra* note 32 at 642; and see *Corporations Agreement* (1997), articles 505 and 506.

53 Later re-named the Australian Securities and Investments Commission, ASIC, in the circumstances referred to below.

54 *Corporations Agreement* (1997), article 601.

55 See *Corporations Agreement* (1997), article 603 (the quotation is from art 603 (5)).

to them of most if not all of the personnel of the CACs who wished this. Service levels at these Offices were to be at least equal to those under the previous state regulators.[56]

The ASC was to be responsible to the relevant federal minister,[57] not MINCO or the states or the territory. However, the ASC was required to guarantee levels of service through the Regional Offices not lower than those in the state or territory under the Co-operative Scheme. Reinforcing this, there was provision for regular reporting on levels of service by the Commission, against a system of performance indicators, to each state or territory, and provision also for the making of complaints about levels of service to MINCO.[58]

In addition, to ensure a minimum level of interchange between the regulator and regional business and professional communities, the Agreement required the establishment of Regional Liaison Committees in each state and territory. These were to meet quarterly, both to receive briefings on the work of the Commission, and to provide the Commission with views on local levels of service.[59]

The Agreement also featured compensation to the states and territory for revenue losses resulting from this assumption of federal control. This was a base amount representing the net income nation-wide from the Co-operative Scheme in its last year of operation,[60] to be adjusted upwards according to movements in the CPI, and distributed in accordance with the proportion of company registrations by state and territory at the commencement of the National Scheme Version 1.[61]

The judicial stigmatisation of National Scheme Version 1 appears to go, not so much to these features, as to the rather more novel features of the National Scheme that *further* set it apart from the Co-operative Scheme. These were designed as much as possible to federalise the legislation, so as to achieve the effect of the former federal legislation. This was done by provisions to have the courts treat the applied law as if it were federal law. Federal regulatory bodies, like the ASC and, in criminal matters, the federal Director of Public Prosecutions

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56 This matter is returned to in more detail below, text in paragraph accompanying and following note 162, below.

57 *Corporations Agreement* (1997), article 302: the relevant federal Minister was first the federal Attorney General, and later the Commonwealth Treasurer: in matters determined by the Treasurer, there is responsibility to the Parliamentary Secretary to the Treasurer, Senator Ian Campbell, from WA. Previously, the Treasurer assigned this area to the Hon Joe Hockey, MP, and former Minister for Financial Services and Regulation.

58 *Corporations Agreement* (1997), article 604, subject to article 302 (ASC responsible and accountable to relevant Commonwealth Minister and to Commonwealth Parliament, "not to State [or Territory] Ministers or … Parliaments"). The matter of these performance indicators and that reporting are returned to below, text at note 162.

59 *Corporations Agreement* (1997), article 605.

60 This is the income the states and territories derived principally from fees under the Co-operative Scheme, less the amounts they appropriated for regulation: the amount concerned was set at $102,000,000. For more on this income and those appropriations, see text at note 139, below.

61 *Corporations Agreement* (1997), articles 701 and 702. This is a different set of proportions from those used for the purposes of transfer payments by the Commonwealth to the states under the auspices of the Grants Commission; the former proportions are currently in issue between at least some of the states and the Commonwealth. See note 111, below. This formula has been continued under the National Scheme Version 2: see text at note 93, below. For the operation of this formula, see Table 9 to this Report.

(the federal DPP), were given the power to administer what juridically was state law. At the same time, in criminal cases and administrative law matters, federal criminal procedure and administrative law governed, not the relevant state or territory law.[62] In civil matters, there was cross-vesting of jurisdiction between state and federal courts, so that any could hear any matter arising under the Scheme, whether the matter was one going formally to state or to Commonwealth law. And in criminal matters state and territory courts were given jurisdiction to hear matters arising under the applied law of another jurisdiction.[63]

(d) *The Constitutional Cloud over the National Scheme Version 1*

This Scheme underwent significant change over the 1990s, both in legislative and administrative matters. The administrative changes are considered in the next Section, when the matter of the changing role of the regions is considered. For now, the focus is on the character of the legislative changes and the uncertainties about the constitutionality of significant parts of the Scheme.

Perhaps the most substantial changes in the National Scheme at the legislative level were made as a result of the Corporate Law Economic Reform Program of the Commonwealth (CLERP). This was a review by the federal government of much but by no means all of the legislation, in the interests of simplifying and modernising it. The idea was to enhance the prospects for business to regulate itself, by making the law easier to understand, and by making it more "relevant" to current conditions.[64] It was accompanied by a shift in responsibility for the law from the federal Attorney-General's department to the Commonwealth Treasury, in line with[65]

> [t]he objective of [CLERP] … to ensure that business regulation is consistent with promoting a strong and vibrant economy and provides a framework which assists business in adapting to change …
>
> Corporate regulation will be revamped to provide a clear and consistent framework which reflects the contemporary business environment and encourages business, large and small, to create wealth, prosperity and jobs.

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62 H.A.J. Ford et al., *Ford's Principles of Corporations Law*, 8th ed. (1997) at para. [3.050].

63 *Ibid* at para. [3.330].

64 For material on the Corporate Law Economic Reform Program, see the Web site for the federal Department of the Treasury. Go to http://www.treasury.gov.au, click Publications, then Bills, Acts and Legislation, then Corporate Law Economic Reform Program. See also Simmonds, Ralph "Dismembering the Corporations Law and other law reform: should something more be added to the law reform agenda?" (1995) 13 Company & Securities L.J. 57. See also text at and reference in note 115, below, for further background on the CLERP enterprise.

65 Quotation from announcement of the commencement of CLERP (March 1997), as set out in Tomasic et al., 2nd ed., *supra* note 12 at 77.

The changes included in 1998 adding to the regulatory responsibilities of the ASC the role of consumer protection in life and general insurance, superannuation and banking. This was accompanied by a name change to the current Australian Securities & Investments Commission (ASIC). This was so that there would be a single regulator with a consistent approach to "advising, selling and disclosure of financial products and services to consumers".[66]

But doubts about the constitutionality of some of the foundations of the Scheme began to grow from this time, with a number of High Court decisions towards the end of the decade. Two decisions, one with respect to the cross-vesting arrangements in civil matters, and the other with respect to the responsibilities of the federal regulatory agencies, were of particular concern.

One decision, *Wakim* in 1999,[67] held that the cross-vesting provisions in civil matters, so far as they purported to vest jurisdiction in federal courts to hear matters arising under state law, were invalid. This was because the provisions in the *Australian Constitution* on the judicial power of the Commonwealth were found to preclude such vesting. The effect of this decision was seen by many practising lawyers to be most unfortunate, as the federal courts had increasingly come to be regarded as the pre-eminent courts in the area of corporations, securities and futures law, displacing the state Supreme Courts, and increasingly (because of its workload) the High Court.[68]

Rather more serious for the National Scheme Version 1 were obiter in the decision in *Hughes* in May 2000.[69] This was a case on the power of the federal DPP to prosecute for offences under Scheme legislation of offering regulated units of interest in non-corporate business ventures without compliance with the scheme of regulation. The case upheld the power to prosecute on the facts on the basis of the federal legislative powers to regulate interstate and foreign trade and commerce, and in relation to external affairs.[70] But the members of the Court went on to say, rather to the surprise of many observers, that only matters falling within federal legislative jurisdiction can properly be made a *responsibility* of a federally created executive agency (such as the DPP, and ASIC).[71]

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66 ASIC, *Annual Report 1997-1998* (1998) at 19 (source of quotation).

67 *Re Wakim; Ex parte McNally* (1999) 198 CLR 511, (1998) 20 LegReg 7b; (1999) 163 ALR 270; (1999) 73 ALJR 839; (1999) 10 Leg Rep 2; (1999) 31 ACSR 99; (1999) 24 Fam LR 669; (1999) 17 ACLC 1055; [1999] HCA 27; BC9903189 (June 17, 1999): see Tomasic et al., 2nd ed., *supra* note 12 at 27 – 28.

68 On the practical results, see *Corplaw Bull*. No 34 (June 2000) (noting inter alia that "[i]n the 24 months up to June 1999, 1500 corporations law cases were filed in the Federal Court or 62 cases each month on average[; but] .. in the period July 1999 to March 2000, only 6 corporations law cases were filed in the Federal Court or less than 1 case each month on average").

69 *R v Hughes* (2000) 202 CLR 535; (2000) 171 ALR 155; (2000) 74 ALJR 802; (2000) 21(8) Leg Rep 2; (2000) 34 ACSR 92; (2000) 110 A Crim R 526; (2000) 18 ACLC 394; [2000] HCA 22; BC200002055; [2000] ACL Rep 120 HC 2 (May 3, 2000): see Tomasic et al., 2nd ed., *supra* note 12 at 28.

70 *Australian Constitution*, s 51 (i) and (xxix).

71 See Ian Govey and Hilary Manson, "Where is the Corporations Law post-*Hughes*?", paper prepared for the Corporate Law Workshop, Fremantle, Western Australia, July 21-23, 2000, and D. Rose, "The Hughes case : the reasoning, uncertainties and solutions" (2000) 29 Univ. West. Aust. L. Rev. 180 (Rose was one of the architects of the National Scheme Version 1).

The effect of this holding was seen by many lawyers to be even more unfortunate than that of *Wakim*, the cross-vesting case. Doubt was cast on, among other things, the arrangements for the ASC, and then ASIC, to incorporate companies under the Scheme.[72] The implications of this, for all of the hundreds of thousands of companies incorporated under the Scheme over the decade of the 1990s, were seen to be extremely serious.[73]

(e) *The Call for What Became National Scheme Version 2 and the Response*

The *Wakim* and *Hughes* decisions, it was said by the federal government, had a most adverse effect on confidence, particularly international confidence, in doing business with Australian companies and investing in them. It was felt also that any solution short of one to validate the National Scheme would have left Australia with a state of affairs like the traditional position of fragmented state corporations law and administration. This was a view that was also expressed by a number of peak national business and professional associations.[74] There are strong echoes here of the business and professional support for the move to National Scheme Version 1.

However, there was no unanimity about either the gravity of the problem, or the Commonwealth's preferred solution, a referral of power by the states to supply the gaps in Commonwealth legislative competence. The principal concerns were about the breadth of any reference, which might be sufficient to permit federal legislation beyond the confines of the National Scheme into matters like labour relations, and about the loss of state powers without at least a popular vote on the matter, as through a constitutional referendum. The latter concern was particularly identified with the then Liberal (conservative) state government in WA.[75]

However, negotiations between the Commonwealth and the states persuaded first New South Wales, and then the other states to agree to the referral solution, facilitated in WA by a change of government, with a change in policy to one endorsing the Commonwealth position.[76] The negotiation process is only partially public, and may have concerned matters beside those appearing in the final Agreement between the Commonwealth and the other parties to National

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72 See Govey & Manson, *supra* note 71 at 16-17.

73 Just such an attack on the validity of an incorporation under the National Scheme, Version 1, was mounted in *GPS First Mortgage v Lynch*, in Govey & Manson, *supra* note 71 at 4

74 See "Financial markets' credibility could be undermined – SIA", Australian Associated Press, July 20, 2000 (Securities Industry Association, Australian Institute of Company Directors, the Business Council of Australia, the Institute of Chartered Accountants in Australia and the Law Council of Australia).

75 See Neale Prior, "WA cedes company powers", *The West Australian* (March 12, 2001).

76 *Ibid*

Scheme Version 2.[77] However, the principal public subject matters of the negotiations were ensuring that the States and the Territory would have to reassess the position at the end of a suitable period before any continuation of the Scheme, and that the Scheme would be confined to matters of corporations and financial products law. The former matter is reflected in the states' referral legislation, while the latter matter is reflected in the new *Corporations Agreement* that is the basis for National Scheme Version 2. Both, together with the rights of referring states to withdraw from the Scheme, are returned to below.

(f) *The National Scheme Version 2*

The solution involved the passage of state legislation[78] referring powers sufficient to cover the content of the previous National Scheme, as well as the subsequently enacted *Financial Services Reform Act 2001* (Commonwealth), returned to below, and further express Commonwealth amendments of the new *Corporations Act 2001* (Commonwealth) and the *Australian Securities and Investments Commission Act 2001* (Commonwealth).[79] The state legislation provides that the references terminate after five years, subject to the possibility of extensions being made[80] and subject also to the possibility of an earlier termination by the state withdrawing from the Scheme.[81] There is a constitutional amendment to be considered for the

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77 Two sorts of concession were referred to in the discussions the authors had with some interview subjects. One was enhanced grant payments promised to secure National Scheme Version 2. There appears to be no public record of these and in that light the authors are sceptical that any such were made that would have substantially advantaged one state over another or the states overall. The other sort of concession referred to was an undertaking by ASIC to give full consideration to using state courts as sites for litigation. This was to respond to concerns that the re-conferral (this time validly) of jurisdiction on federal courts would deprive state courts of an appropriate 'share' of National Scheme litigation. Again, this concession appears not to have been the subject of public discussion, but it is more plausible it would have escaped media attention.

78 See e.g. *Corporations (Commonwealth Powers) Act 2001* (WA) (in force June 29, 2001). It is worth noting s 1 (2) and (3) of this legislation:

> (2) The purpose of this Act is to refer certain matters relating to corporations and financial products and services to the Parliament of the Commonwealth for the purposes of section 51(xxxvii) of the Constitution of the Commonwealth, so as to enable that Parliament to make laws that apply of their own force in the State, instead of those matters being dealt with by the Corporations Law and other applied laws.
>
> (3) Nothing in this Act is intended to enable the making of a law pursuant to the amendment reference with the sole or main underlying purpose or object of regulating industrial relations matters even if, but for this subsection, the law would be a law with respect to a matter referred to the Parliament of the Commonwealth by the amendment reference.

79 Corporations Bill 2001 (Cth) Explanatory Memorandum, para. 4.10.

80 See e.g. *Corporations (Commonwealth Powers) Act 2001* (WA) (in force June 29, 2001), s 5, read with s 6. This was one of the agreed bases for the National Scheme Version 2: see Butterworths [Australia], *Australian Corporations Legislation 2003* (Sydney: Butterworths, 2003) at 23 (joint statement of parties to Scheme marking the agreement that led to the Scheme).

81 See e.g. *Corporations (Commonwealth Powers) Act 2001* (WA) (in force June 29, 2001), s 7. See on the right of withdrawal *Corporations Agreement 2002* (2002), Art. 901 (right of withdrawal on giving 6 months' notice).

longer term future.[82] This would overcome the weaknesses of the referral arrangement that go particularly to its limited duration and its vulnerability to withdrawals.[83]

The idea is that the existing components of the former National Scheme are replaced by federal legislation enacted (and in force July 15, 2001) by virtue of a combination of State legislative power referred to the Commonwealth under *Australian Constitution* s 51 (xxxvii), primarily, as well as other Commonwealth legislative power.[84] This is in effect to restore the *status quo ante* before the constitutional cloud arrived. Thus, there is federal administration of the Scheme, curial jurisdiction as was originally intended, and the application of federal statutory interpretation rules, federal criminal procedure and federal administrative law.[85] There continues to be the notion of companies incorporated in a particular state or territory, but for non-corporations law purposes.[86]

The resultant law embodies the content of the principal Commonwealth statutes of the National Scheme Version 1, right down to their numbering.[87] However, there have been some changes to reflect the direct application of the text as federal law,[88] and some "anomalies" in the previous laws have been corrected.[89] And there is an intricate transitional regime, designed to ensure that the prior law's content will apply to previous dealings, but with such changes as are "necessary".[90]

The matter of the validity of previous administrative activity under the National Scheme Version 1 is also dealt with, by state legislation to validate that action.[91]

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82 See Joint Press Release Cth AG and Min for Financial Services July 27, 2000 (at http://www.law.gov.au/aghome/agnews/2000newsag/jointaghockeycorps.htm, reporting the preliminary form of agreement which was finalised as reported in http://www.law.gov.au/aghome/agnews/2000newsag/joint29%5F00.htm, both accessed February 28, 2002). This is to be addressed by the Ministers of the parties "as soon as possible after the third anniversary of the commencement [of the Scheme]": *Corporations Agreement 2002* (2002), Art 1005.

83 See Tomasic et al., 2nd ed. *supra* note 12 at 69. It is important not to overstate this vulnerability, however: see text at notes 189 to 191, below.

84 Corporations Bill 2001 (Cth) EM para. 5.4; and see Tomasic et al., 2nd ed., *supra* note 12 at 68.

85 Corporations Bill 2001 (Cth) EM para. 4.9.

86 See Corporations Bill 2001 (Cth) EM paras. 5.18-5.25.

87 See Corporations Bill 2001 (Cth) EM para. 5.3. For a useful overview of the practical issues in the transition to the new regime, see Law Society of Western Australia, *The New Commonwealth Corporations Act* [:] *Trials and Tribulations of Transition* (2001).

88 Thus, there is no longer a need for a specified interpretative regime: the *Acts Interpretation Act 1901* (Commonwealth) will apply, but as at November 1, 2000 – *Corporations Act 2001* (Cth), s 5C.

89 See Corporations Bill 2001 (Cth), EM Part 7. However, considerable anomalies remained, such as that of the operative definition of "associate": see *Corporations Act 2001* (Cth), as originally enacted, s 9 "associate" and ss 10 ff.

90 *Corporations Act 2001* (Cth) s 1401. Difficult technical questions remain, however. Thus, it is not clear how this deals with changes in the *Act* of the sort represented by the response to the "direct" application of the doctrine of separation of powers: see Corporations Bill 2001 (Cth) EM paras. 5.58, 5.59.

91 See Corporations Bill 2001 (Cth) EM para. 4.11 (referring to this as part of the arrangement with the states involved in the referral of power); and for such legislation for Western Australia, see *Corporations (Ancillary Provisions) Act 2001* (WA).

The agreement by the states and the Northern Territory to these arrangements was expressed in a new *Corporations Agreement 2002*, formally concluded in that year, to replace the 1997 document. In general terms, it continues the institutions and arrangements of that document, most notably, MINCO, Regional Commissioners, Regional Offices[92] and Regional Liaison Committees, as well as the compensation formula for the benefit of the states and the territory for their vacation of the field.[93]

Perhaps the most notable textual changes from the 1997 to the 2002 documents are in relation to MINCO, and they appear to represent significant concessions to the states by the Commonwealth reflective of its anxiety to gain firm regulatory authority in this area.[94] There is provision for a veto by at least 4 state Ministers where they consider a Commonwealth amendment to National Scheme laws is "for a purpose other than the formation of corporations, corporate regulation or the regulation of financial products or services". This provision is for a veto by such a group of *any* amendment to the National Scheme laws, whether or not it is one (such as in relation to securities regulation) on which otherwise the Commonwealth would be entitled to proceed without a vote of MINCO.[95] And for changes in other areas, for which MINCO approval is required, the states have an enhanced voting position: the approval of at least 3 State or Territory Ministers is now required, where previously in effect 1 would have done.[96]

This intricate history concludes with the enactment in September 2001 of the *Financial Services Reform Act 2001* (Commonwealth) (the FSRA) (in force on March 11, 2002). This legislation was the product of a policy development process, the Financial System Inquiry (the FSI), that had a common inspiration with, and came to be subsumed into, the CLERP enterprise.[97] Like CLERP, the FSI was a process driven by the Commonwealth Treasury. The FSI was meant to produce recommendations

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92 As under National Scheme Version 1, in each state and each of the Australian Capital Territory and the Northern Territory. The sizes of these offices as shown in *Annual Report 2001-2002* (2002), varies as follows (expressed as equivalent full-time staff averaged over the year):

- Victoria, with 543;
- NSW, with 450;
- Queensland, with 114;
- WA, with 84;
- South Australia, with 46;
- the Australian Capital Territory, with 23;
- Tasmania, with 16; and
- the Northern Territory, with 8.

93 For this formula, see text, *supra* at and of notes 60 and 61. For its operation, see Table 9 to this Report.

94 See Whincop (2001), *supra* note 34 at 271 (ascribing its concern to the coalition of interest group forces to which it was responsive).

95 See *Corporations Agreement 2002*, art 508 (Ministers can cause a meeting of MINCO to be called; Commonwealth must not pursue amendment if at that meeting 4 or more state Ministers vote against the amendment).

96 *Corporations Agreement 2002*, art 507 (2).

97 P.S.B. Hutley et al., *An Introduction to the Financial Services Reform Act 2001* (2002) at 1.

> … on the nature of the regulatory arrangements that will best ensure an efficient, responsive, competitive and flexible financial system to underpin stronger economic performance, consistent with financial stability, prudence, integrity and fairness.[98]

The FSRA's changes advance those that, as has been seen, were made in 1998 to the role of the federal regulator and resulted in its being renamed ASIC. The changes involve bringing together the regulation of all "financial products", including specifically securities, derivatives, certain insurance products, certain superannuation products, retirement savings accounts, and foreign exchange transactions other than spot ones.[99] This is principally for the purposes of licensing of markets and clearance and settlement facilities for financial products; licensing and conduct regulation of providers of intermediation services in relation to financial products, such as dealing and advising; financial product disclosure; and misconduct in relation to transactions in financial products.

Under the FSRA there is a new regime for the licensing of markets and clearing and settlement facilities for financial products that is meant to represent a single simplified form of the regimes it replaces. This is designed so as not to inhibit new arrangements, such as combined securities and futures exchanges, and so as not to restrict the possibilities for competition between providers.[100]

The FSRA is meant to establish a single licensing and conduct regulation regime for all financial services providers, although one meant to allow for differences between different sorts of provider. It covers not only securities dealing and advising, but also such as futures and insurance brokerage. It is designed to readily accommodate multi-product operations.[101]

The FSRA is further meant to provide for

> consistent disclosure requirements to all 'financial products', although with flexibility in the legislation to allow for significant differences between products. The requirements comprise point of sale disclosure through a Product Disclosure Statement, ongoing disclosure and periodic reporting requirements, advertising requirements, and an obligation to provide confirmation of transactions.[102]

This is intended to replace legislation that was seen to call for product disclosure of a "fragmented and product specific nature", to the detriment of a "financial services industry now offering a range of financial products and services in relation to those products".[103]

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98 Quotation from the statement for the Treasurer, June 1996, establishing the Inquiry, in the Financial System Inquiry, *Financial System Inquiry Final Report* (1997) (the Wallis Report) at vii.

99 See Hutley et al., *supra* note 97 at [1.16]-[1.32]; and *Corporations Act* 2001 (Cth), Part 7.1, Div 3.

100 See Hutley et al., *supra* note 97 at [1.6], [1.7]; and *Corporations Act* 2001 (Cth), Part 7.2 ("Licensing of financial markets") and Part 7.3 ("Licensing of clearance and settlement facilities").

101 See Hutley et al., *supra* note 97 at [1.5]; and *Corporations Act* 2001 (Cth), Part 7.6 ("Licensing of providers of financial services") and Part 7.8 ("Other provisions relating to conduct etc connected with financial products and services, other than financial product disclosure").

102 Financial Services Reform Bill 2001, Explanatory Memorandum, para. 2.33. See *Corporations Act* 2001 (Cth), Part 7.9.

103 Financial Services Reform Bill 2001, Explanatory Memorandum, para. 2.32.

And the FSRA is also meant

> to consolidate the different sets of provisions [scattered across the previous law on general market misconduct and insider trading], and then extend the single set of provisions to cover all financial products that may be traded on a financial market.[104]

This goes to the perceived problem that provisions of those sorts were not applicable, or applicable in the same terms, to all such products, which was

> undesirable from a policy perspective, and contrary to the aim of the [FSI enterprise] to regulate functionally similar financial products in a consistent manner.[105]

5. Impact on Control Over Regulatory Policy; Impact on Regulatory Effectiveness – From Co-Operative Scheme to National Scheme Version 2

The first part of this section will consider the impact of each of National Scheme Version 1 and National Scheme Version 2 on regulatory policy, including legislative change, and the approach taken to the application of the law where there is scope for the exercise of significant judgment or discretion.

The second part of this section will consider the impact of each of National Scheme Version 1 and National Scheme Version 2 on the effectiveness of the resultant regulation, including the enforcement of the law as well as the administration of its requirements.

The assessment here draws heavily on 12 years of published ASIC *Annual Reports*, as well as on interviews the researchers conducted in Perth and elsewhere during the preparation of this Report.[106] It transpires that there is very little published research that directly bears on the research topics of this section, the likely reasons for which will be considered below. There is, as might be expected, a great deal of literature that explores the technical issues in and the practical ramifications of the changes.

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104 Financial Services Reform Bill 2001, Explanatory Memorandum, para. 2.77; and see *Corporations Act* 2001 (Cth), Part 7.10.

105 Financial Services Reform Bill 2001, Explanatory Memorandum, para. 2.76.

106 The authors selected interview subjects based on the authors' understanding (borne out in nearly all cases) of the subjects' closeness to the introduction, continuation or operation of the National Scheme Version 1 or National Scheme Version 2 or in some cases both. The interview subjects were in almost all cases at or before the interview provided with a document that described the Project and the question areas the authors were keen to discuss with the interview subjects to the extent that they were able to address them. Subjects were asked to review the document before beginning to talk with the authors, or the one of them available for the interview. The interview proceeded thereafter in a relatively unstructured way to permit the subjects to raise issues they considered important. In some cases more than one subject was interviewed at a time. The subjects were subsequently provided with accounts of their interview that the authors had compiled and they were asked to correct these accounts.

(a) *The Impact of the National Schemes on Regulatory Policy*

The concern here is the matter of policy formation, whether that policy is translated into legislative form (such as the Australian CLERP amendments) or new policy of the regulator (such as the developing body of Policy Statements and Practice Notes of ASIC).

As has been noted, it was feared at the time of the push to what ultimately became National Scheme Version 1 that the policy needs of smaller or regional businesses and financial product markets, as opposed to national ones, would tend to be lost sight of in the new national system.

At the level of policy needs in relation to legislative change, the impact of National Scheme Version 1, at least, is hard to evaluate. Undoubtedly, there was a diminution in the role of state governments in the formulation of legislative policy. However, there were and continue to be arrangements for capturing local input for national policy making. These arrangements appear to be working reasonably well. Whether they work to take account of local preferences *as well* as would local input into *local* regulation is harder to evaluate.[107] However, there appears to have been no significant push to unwind the National Schemes on this account.[108]

At the level of state or territory government input, the initial focus is on MINCO and its associated processes, such as the meeting of government officers to prepare for MINCO meetings. Under the previous Co-operative Scheme, as has been seen, it was necessary for there to be majority approval of amendments of scheme legislation from the Ministerial Council set up under its Formal Agreement. Apart from changes in voting rules (which, as will be considered, might have been significant), there is little to distinguish this from the arrangements under National Scheme Versions 1 and 2.

A subtle but significant difference may, however, lie between the Co-operative Scheme and National Scheme Version 1, on the one hand, and National Scheme Version 2, on the other. That difference may lie in the character of the uniform law in issue. In the first case, the law is *state* law, referentially incorporating federal law. In the second case, National Scheme Version 2, it is *federal* law applicable of its own force by virtue of a referral of power. There is some reason to think that this might have influenced the extent to which MINCO was a significant site for input into legislative policy.

In the first years of National Scheme Version 1, MINCO was apparently active in legislative policy terms, as was its predecessor under the Co-operative Scheme.[109] However,

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107 On the literature on the political economy of federalism, the answer would almost certainly have to be no, they could not be expected to work that well. See the work of the late Michael Whincop, especially his "The Political Economy of Corporate Law Reform in Australia" (1999) 27 Federal L. Rev. 77 at 77 ("decentralization more receptive to local conditions").

108 As Whincop (1999), *supra* note 107, concedes.

109 However, it is difficult to find for National Scheme Version 1 indications of the sort of intervention in legislative policy development of the sort readily to be found for the Co-operative Scheme: see e.g. NCSC, *Sixth Annual Report 1984-1985*, Parl. Paper No 38/1986 at 37 (MINCO directed NCSC to look into adequacy of rules for investor protection and disclosure in emerging new securities markets).

it seems to have become less active in *that* respect as time went on. Particularly now, under National Scheme Version 2, with the removal of state 'ownership' of the law, there might, in part for that reason, be less concern for the detail of that law's content. There is, for example, a trend discernible in the *Annual Reports* of the national regulator to make less and less mention of the work of the Council. It is necessary to realise, however, that the national regulator throughout has been simply an observer at these meetings. However, it is difficult to find any legislative or other policy initiative that is publicly attributed to MINCO.

It is worth noting also that in the areas of the legislation setting up the National Schemes and representing securities regulation – such as fundraising, licensing and take-overs – there was a shift in the voting rules from the Co-operative Scheme to National Scheme Version 1. Under the former, the principle in the Ministerial Council was majority rule; under the latter, the Commonwealth had to and must still consult on these matters, but could and can legislate without agreement. However, there is no evidence of greater MINCO involvement in policy matters where there continues to be a vote. And there appears (so far) to be no impact from the increase in the states' voting powers in the areas reserved for MINCO approval under National Scheme Version 2 – which may suggest that the issue of 'ownership' of the law offsets the voting rights change.

It may, however, be of greater significance that the National Schemes for the most part replaced the state regulators with a national one, to which most of the employees of the state regulators who were in the area of financial services regulation and policy transferred. There did continue to be a role for state and territory regulators in relation to some local financial institutions, such as building societies and credit unions. These, however, in the early 1990s came to be regulated by a body established by the states and territories, the Australian Financial Institutions Commission, whose jurisdiction in 1999 the parties passed over to the national regulator.[110]

The point here is that over the National Scheme period the pool of state or territory government expertise in the development of financial services regulatory policy has shrunk dramatically. This may also help to account for the reduction in the role of MINCO in policy input into legislative change. This is except for matters relating to the details of the Schemes themselves, where there appears to be an overlap with the work of the Standing Committee of [federal, state and territory] Attorneys General.[111]

MINCO is not the only possible site for local input into legislative policy change, however. The *Corporations Agreements* that deal with MINCO also provide for at least three other sites.

One such site is the body that under the National Schemes appears to be contemplated as the principal source of technical advice on legislative policy change, what was the Companies and Securities Advisory Committee (CSAC) and is now the Corporations and Markets Advisory

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[110] ASIC, *Annual Report 1998-1999* (1999) at 2.

[111] An example of such a matter is that of the basis upon which the states and territories are compensated for their vacation of the area of corporate and financial services law and regulation, currently in issue in MINCO: for the basis for that issue, see *supra* note 60.

Committee (CAMAC). Under the Co-operative Scheme the corresponding body was the Companies and Securities Law Review Committee (CSLRC), established in 1984, some two years after the Scheme came into operation, to review the law as instructed by MINCO.[112] Under the National Schemes, the national regulator's formal role is limited in respect of law reform, to advising the government on changes in the law to overcome problems in administration it encounters.[113] Members of the specialist advisory body and its Legal Sub-committee are expected normally to include at least one locally resident representative from each state or territory, appointed from a panel of persons nominated by the relevant state or territory Minister.[114] This has apparently largely been the case, and these bodies have been active producers of law reform proposals throughout both National Schemes, as was their Co-operative Scheme predecessor.

It is important to realise, however, that the advisory body under National Scheme Version 1 was not in fact the source of the CLERP reform proposals. The CLERP enterprise succeeded the work of the Corporate Law Simplification Taskforce, which likewise was outside the specialist advisory body.[115] As has been indicated, CLERP has been located in Treasury, and was initiated after responsibility for the National Scheme was shifted to the Treasurer. CLERP has used a business regulation advisory group, with members of the group drawn from representatives of national peak organisations, such as the Business Council of Australia, the Australian Institute of Company Directors and the Australian Corporate Lawyers Association.[116] CLERP's work, particularly in the fundraising area, has come in for praise in some quarters in WA, for its better accommodation of the needs of the sorts of smaller capitalisation issuers more typical of the state than for NSW or Victoria. The literature has some strong dissents from this sort of view, however.[117]

Apart from CSAC and CAMAC, the *Corporations Agreements* provide for two other sites for local influence on national legislative policy, although neither appears to contemplate them having this as a principal role. This is because these sites relate to the national regulator and its work. One such site is the institution of the Regional Commissioners of the national regulator, upon whose appointments the *Agreements* provide the Commonwealth must consult with the relevant state or territory Minister.[118] The other such site is the Regional Liaison Committees to be established by the Regional Commissioners.[119] Both of these institutions were mainly intended to address issues of the adequacy of local levels of service delivery by the national regulator. Given the national regulator's (limited) role in law reform, however, there is

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112 H.A.J. Ford and R.P. Austin, *Ford's Principles of Corporations Law*, 6th ed. (1992) at 13.

113 See Ford, 6th ed., *supra* note 112 at 941-942.

114 See *Corporations Agreement* (1997), art 606; *Corporations Agreement 2002* (2002), art 605.

115 See Whincop (1999), *supra* note 107 at 79-80 and references there on the Taskforce.

116 See e.g. CLERP, *Proposals for Reform: Paper No 2* [:] *Fundraising* [:] *Capital raising initiatives to build enterprise and employment* (1997).

117 See Whincop (1999), *supra* note 107 at 87.

118 See *Corporations Agreement* (1997), art 603 (3); *Corporations Agreement 2002* (2002), art 602 (3).

119 See *Corporations Agreement* (1997), art 605; *Corporations Agreement 2002* (2002), art 604.

also scope for local input to the performance of that role. However, there appears to be nothing made of this aspect of their work in the literature or in the discussions the authors of this Report have had with actors in WA.

These last two sites for local policy input would, however, assume much greater significance, one would have thought, in relation to the policy that the national regulator *itself* can make. While neither the ASC nor ASIC had or has formal rule-making power,[120] both, like their predecessor the NCSC, have been active makers of policy pronouncements in the form of Policy Statements, Practice Notes and Class (exemption) Orders that structure or represent the exercise of their discretion in particular cases.[121] The national regulator has throughout its history used a range of arrangements for consultation on matters of regulatory policy. These include Regional Liaison Committees, and their continuing significance appears to be greatest in states like WA rather than NSW or Victoria.

However, the national regulator has used other consultative arrangements as well. If anything these appear to have received greater prominence in more recent years, as the national regulator has developed more nationally integrated institutional arrangements. Those arrangements are returned to in more detail under the next topic, Impact on Regulatory Effectiveness. Here the focus is on what has accompanied them in terms of new forms of local input into regulatory policy.

In this respect the role of the Regional Commissioners has changed. The emphasis now is on their role as regional facilitators, informing business and investors in the regions of the work of ASIC and of what is important to it, and providing local information to ASIC as well as connecting those from their regions with the appropriate ASIC officers. All of them have particular responsibilities in relation to the functional areas (or "Directorates") into which ASIC has organised itself, with three of the eight heading such an area, including one who heads the Regional Coordination & International Relations Directorate.[122] The WA Regional Commissioner has as his "national role" that of Markets and Policy Adviser in the Policy & Markets Regulation Directorate.[123] He has been recognised in WA as particularly active in linking locals with those in this and other Directorates responsible for policy and development.

The national regulator has also increasingly stressed under the heading "Community Involvement" its relations with a body, now called the Consumer Advisory Panel, created to liaise more effectively with the community of consumers of financial products; emphasis has

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120 There is one body in the National Scheme that now does have such power, the Take-over Panel, formerly the Corporations and Securities Panel, which succeeded to the dispute resolution authority in the take-over area of the national regulator under the Co-operative Scheme, the NCSC. The removal from the national regulator of this power was considered to be an important part of National Scheme Version 1 (see Ford & Austin, 6th ed., *supra* note 112 at 786): in the terms of the present Report, it had relatively little impact as it was the substitution for one national regulator of another.

121 See H.A.J. Ford et al., *Ford's Principles of Corporations Law*, 11th ed. (2003) at 74, on these.

122 Effective in the 2000-2001 financial year: see ASIC, *Annual Report 2000-2001* (2001) at 9.

123 *Ibid* at 40, 41.

also been laid on its regular meetings with representatives of 18 peak (national) industry and professional associations.[124]

In addition to these institutional arrangements, the national regulator has had a strong policy of having the Commissioners and the Executive Directors, as well as Regional Commissioners and other senior officers, travel throughout Australia on a regular basis. In part, this has been to ensure connections with local business and professional communities are made and maintained. The practice is in fact so perceived, at least in WA.

The effectiveness of these arrangements, to give a local voice in national policy development, appears to be fairly readily conceded in WA. There appear to be very few complaints of a lack of input opportunities, and no indication that either National Scheme Version 1 or National Scheme Version 2 resulted in significant change for the worse. Given the way that those Schemes' structures for input into law reform tend to mirror, and in fact further elaborate, their predecessor's arrangements to capture organisational and individual input,[125] this is unsurprising.

Where there does appear to be local dissatisfaction, at least in WA, with the impact of the National Schemes, particularly National Scheme Version 2, is in relation to regulatory operations. This is considered next.

(b) *The Impact of the National Schemes on Regulatory Effectiveness*

The overall characteristic of the National Schemes that contrasts most sharply with their predecessor, the Co-operative Scheme, is the resources spent on the national regulator and the capacity to use them effectively.

The perception of inadequate resources spent on regulation was one of the main criticisms of the Co-operative Scheme. A related theme was the difficulty in effectively prioritising the use of, and mobilising and deploying, those resources that were available, as well as inconsistencies in regulation, that was created by having eight regulatory organisations. This was even although they were subject to the overarching power of the NCSC to set overall policy and to provide for practice standards in regulation.

The NCSC in practice was active in the areas both of policy creation and of practice standard development.[126] However, it lacked the authority to determine resourcing for the constituent organisations, or even, it was said, to give directions as to "facilities and services

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[124] See ASIC, *Annual Report 1999-2000* (2000) at 20 (section on "Community involvement"), where this emphasis becomes noticeable.

[125] The crucial matter for local input purposes may in fact be the way both the Co-operative and the National Schemes feature uniformity arrangements involving the use of federal law. Prior to the Co-operative Schemes there was a trend to such arrangements, but also some significant local divergences, up to the 1960s: see Whincop (1999), *supra* note 107 at 101. The matter of the relative lack of significant state divergences prior to the federalized arrangements appears to be important to understanding the Australian arrangements, a matter returned to in Section 8.

[126] See NCSC *Annual Reports* (various), which itemize both of these sorts of activities.

available to its Delegates [the CACs]".[127] The CACs in practice adopted different interpretations of the uniform (federal) legislation that applied as state or territorial law in their jurisdictions.[128] The NCSC in practice was seen to be under-resourced for adequate enforcement activity itself,[129] while the CACs that might between them have made up most shortfalls were, in practice it was said, not always able to pool their efforts in a timely or effective way.[130]

(i) Resourcing of the Regulator(s)

The basic resource picture for the National Schemes by comparison with the Co-operative Scheme is easy to paint. At the time of establishment of the National Scheme Version 1, in 1991, the most widely published estimate was that about AUD$70 million was spent annually in total on the state and territory regulators,[131] to which needs to be added the amount spent on the NCSC of about $7 million.[132] By comparison, the corresponding amount spent in the first complete reporting year (1991-1992)[133] of the ASC, the replacement for that regulatory complex, was AUD$129.6 million.[134] That amount fluctuated over the subsequent period, from a low of AUD$123.2 million in 1997-1998[135] to a high of AUD$146 million in 2001-2002.[136] Although it is true to say that especially in recent years the responsibilities of ASIC have gone beyond those of previous regulatory complex, as was indicated in Section 5,[137] this still represents a significant increase.

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127 *Role of Parliament* (1987), *supra* note 32 at 40 (submission of Confederation of Australian Industry, source of quotation).

128 *Ibid*, 41-44 (various examples).

129 See Ford, 6th ed., *supra* note 112 at 13.

130 See Cameron (2002), *supra* note 8, para. 3.5 (referring to information gleaned from senior officer of ASIC with experience of the Co-operative Scheme – or so it would appear).

131 See Ramsay (1990), *supra* note 33 at 171 (newspaper estimates).

132 The NCSC for its last complete reporting year was funded by state, territory and Commonwealth governments in the total amount of AUD$6.7 million (AUD$7.6 million in the previous year): see NCSC *Eleventh Annual Report and Financial Statements 1 July 1989 to 30 June 1990* (1990) at 76.

133 As may by now have become apparent, reporting periods for business and financial institutions in Australia often follow the fiscal year in this country, which is July 1 to June 30 of the following year.

134 This is the amount of the Parliamentary appropriation for operating purposes, including resources provided free of charge: see ASC, *Annual Report 1991-1992* (1992) at 93 (Note 2).

135 ASIC, *Annual Report 1997-1998* (1998) at 64. The reduction in funding is discussed in the later text.

136 ASIC, *Annual Report 2001-2002* (2002) at 96: this is the most recent such report available to the authors of this Report, as at September 26, 2003.

137 The principal additions were, as has been seen, on July 1, 1998 the responsibilities for consumer protection in matters previously the responsibility of the competition regulator, the Australian Competition and Consumer Commission, most notably in superannuation (pension plans), insurance, deposit taking and managed investments (pooled investment arrangements), for which additional funding in the order of AUD$23 million was to be provided: see ASIC, *Annual Report 1997-1998* (1998) at 13. There have been further additions since then, as has also been seen, by the *Financial Services Reform Act 2001* (Cth), for which further increased funding over the 4 years from 2001-2002 to 2004-2005 in the order of AUD$90.8 million has been promised: see ASIC, *Annual Report 2001-2002* (2002) at 1. Reported disaggregations of the costs of the original jurisdiction and the added jurisdictions appear at the request of MINCO, in *Annual Reports* of ASIC, from that for 1999-2000, and show in the most recently published report the original jurisdiction as costing AUD$149.2 million, while the additional jurisdictions cost AUD$10.7 million: see ASIC, *Annual Report 2001-2002* (2002) at 77.

It should also be noted, however, that the funds earned by the regulatory schemes and remitted to consolidated revenue, under the Co-operative Scheme to the States and territories, and under the National Schemes to the Commonwealth, have consistently been significantly larger than these operating provisions. In the last complete reporting year of the Co-operative Scheme the total amount nation-wide is estimated at AUD$200 million,[138] which may be an over-estimate, as the corresponding figure for the first complete reporting year of National Scheme Version 1 was AUD$189.8 million.[139] That sum has since fluctuated from that low to the most recently reported figure of AUD$379 million.[140] This implies that the proportion of this 'operating revenue' represented by the expenditure on regulation under the Co-operative Scheme was between 39% and 41%, while the corresponding proportions under the National Schemes[141] have been from a high of 65% early in National Scheme Version 1 to a low of 39% in the most recent reported year.

In assessing the revenue earned and resources expended on the Australian arrangements, by comparison with similar regulatory arrangements elsewhere, it might be concluded that Australia is in fact a relatively high cost jurisdiction.[142] However, the costs in this country need to be set in the context of the unusually broad scope of the Australian arrangements.

In a recent survey of costs of capital markets regulation world-wide, the following cautionary note was sounded:

> Because of the factors listed above [including differences in regulatory responsibilities], we caution against using the table to conclude that regulation in any individual country is truly more cost efficient than regulation in any other country.[143]

For Australia, that caution in respect of regulatory responsibilities is particularly apt. The figures for Australia given here (and in the survey) include non-securities regulation costs.

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138 Ramsay (1990), *supra* note 33 at 171 (newspaper estimates).

139 ASC, *Annual Report 1991-1992* (1992) at 100. Another reason for thinking this is the provision for compensation to the states and territory in the Corporations Agreement underpinning National Scheme Version 1: see *supra* note 60.

140 ASIC, *Annual Report 2001-2002* (2002) at 1.

141 This *ignores*, however, the compensation the Commonwealth pays to the states and to the Northern Territory under the *Corporations Agreements*, which started at AUD$102 million plus CPI for each financial year from and including 1989-1990: see *Corporations Agreement 2002* (2002), Art 701; and see *supra* note 61, and Table 9 at the end of this Report. This should probably be included as an 'operating cost' of the National Schemes Version 1 and Version 2, but not one of regulation itself. It still leaves a significant 'operating margin' that has not escaped notice: see Tony Harris, "Business Paying Taxes Disguised as Fees" Australian Fin. Rev. (May 19, 2000).

142 Just such conclusions have been drawn by some observers, including some making submissions to the Committee, from the table "Appendix 8: Indicators of the costs of regulation in different jurisdictions" to the UK Financial Services Authority's *2002-2003 Annual Report* (http://www.fsa.gov.uk/pubs/annual/ar02_03/ar02_03app8.pdf).

143 *Ibid.* We note that the Canadian Listed Company Association provided a submission to the Committee arguing against centralization with reference to the information in the FSA tables relating to Australia. We would respond to that submission, by reference to the FSA note accompanying, and the text that follows, this note.

Those costs include the costs of regulating dealings in financial products that are not securities (eg consumer regulation of bank deposits); the costs of enforcement that are not related to securities regulation (eg banning from management directors who have committed offences under the legislation; insolvent trading actions); the costs of running the service of registering and maintaining the registers for companies;[144] and the costs of running the register of company charges.[145]

Further appreciation of the resource pattern for the national regulator can be gained from looking at its staffing. The aim initially was to have approximately 1,800[146] full-time equivalent staff.[147] The National Schemes' regulator never attained this level, with a total staff complement ranging from a reported high of 1,579 in 1994[148] to a reported low of 1,152 in 1998.[149] The trend has since then been up, but only relatively modestly, to 2002's 1,284,[150] although with the resource increase foreshadowed that has been referred to the upward trend may intensify.

The widely shared view of the impact of the National Schemes that unites both those who were concerned at its introduction, as well as those altogether more welcoming, has been strongly that significant additional resources were indeed made available to the regulator, particularly in the early years of National Scheme Version 1.

At the same time there has been a view that with the waning of the political imperative to direct resources to the carry-over investigatory and enforcement work of the ASC dealing with the "excesses of the 1980s"[151] resourcing may again become a significant issue. This is

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144 Unlike the first two, which are likely no more than about 5% each, this is a major cost, in IT infrastructure and servicing terms, from the indications in the ASIC *Annual Reports*. However, it should be noted that disaggregated figures are not available to the authors of this Report: their views here are guesswork.

145 There is no equivalent to this in Canada, except for security granted to Canadian banks under the *Bank Act*: registers of other personal property security interests are of course run at the provincial level.

146 This is the number referred to in ASC, *Annual Report 1996 -1997* (1997) at 53 (referring at a time of budgetary cut-backs to need to abolish senior staff positions put in place when this level of staffing was contemplated).

147 As will become apparent from the next few notes, the description of staffing levels in ASC/ASIC Annual Reports sometimes uses head counts, and sometimes uses FTEs. The latter is the preferred form in most recent years, reflecting the increased use of contract or part-time staff. However, the national regulator has throughout the period been very largely dependent on full-time staff; and the emphasis here is on overall trends, especially in the WA Regional Office.

148 ASC *Annual Report 1993-1994* (1994) at 61 (apparently a head count figure).

149 ASIC, *Annual Report* (1998) at 51 (again, head count it seems). The next report, ASIC *Annual Report 1998-1999* (1999) commences the practice of reporting by FTEs, and also restates the 1998 figure as 1165 FTEs, the lowest such figure reported.

150 FTEs: ASIC, *Annual Report 2001-2002* (2002) at 68.

151 A recurrent theme in the Chairman's reports in the early years of National Scheme Version 1 was the work of the regulator on the major investigations these "excesses" had led to: see e.g. ASC, *Annual Report 1991-1992* (1992) at 5 (substantial completion of 16 carry-over investigations, with two exceptions ongoing). These investigations were inherited from the CACs in a number of cases, and some involved more than 15 full-time staff in some of the Regional Offices, staff whose sole job was to work on one. With the completion of those investigations, many of those staff were released. This caused significant fluctuations in the numbers in the WA Regional Office, for example.

particularly with the regulator's increasing responsibilities. There is also perceived to have been an environment of tightly restrained spending on government activities generally, from the middle of the 1990s at least,[152] and at least until recently.

In particular, the reduced staffing levels in the WA Regional Office have been noted by industry observers in this state, and the numbers are striking. That Office went from a high of 162 staff (10.3% of the national total) in 1994[153] to a low of 75 in 2001 (6.14%),[154] although the trend appears to be back upwards most recently.

However, there is less intense concern on this account than might be imagined, notwithstanding the focus on local service levels in the *Corporations Agreements* that reflected and continues to reflect local concerns in this state. This may in fact evidence the effectiveness of the national regulator's use of its national and regional resources, which is reached next.

(ii) Impact in Terms of Resource Use Planning, Resource Mobilisation and Resource Deployment

Perhaps at least as significant as the resources available may be the ability of the regulator to mobilise them effectively. The critique of the CACs that was most pointed is focussed here. This is because their severest critics fairly readily conceded that they were under-resourced. The issue was identified, not only in terms of their shortfalls in the capacity for effective co-operation, already referred to, but in terms of a "culture" in the CACs, or at least some of them, that was directed more to punctilious administration of the law and less to sophisticated pro-active regulation using the tools of the new learning on effective and appropriate contributions to social ordering by government instrumentalities.[155] This punctilious administration was particularly associated with the close scrutiny of prospectuses for strict compliance with the letter of the requirements of the time. While this view may not have been applicable equally to all of the CACs, altogether fair for those to which it was applied, or even universally shared, it was fairly widely held, if not always expressed in these terms.

The National Schemes' regulator can present an impressive record of achievement, notwithstanding the resource fluctuations described, in a regulatory environment that, as has been indicated, has changed dramatically for it, at least since 1998. This achievement may be seen most subtly in what on balance are muted criticisms of its work, in the region perhaps most critical of the Schemes, WA, over the period when the regulator faced its greatest challenges.

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152 This preceded the election in 1996 of the current government: see ASC, *Annual Report 1994-1995* at 11.

153 ASC, *Annual Report 1993-1994* (1994) at 61.

154 ASIC, *Annual Report 2000-2001* (2001) at 56.

155 See McQueen, *supra* note 9 at 44; for an example of this learning that has been of interest to the current national regulator, ASIC, see Malcolm K. Sparrow, *Imposing Duties: Government's Changing Approach to Compliance* (1994).

Nationally, the ASC/ASIC has been able to show some highly positive survey results from those its work touches. The national regulator has made a point of commissioning regular "independent" surveys of samples of them.[156] The earliest of these on which it reports, done in 1994, indicated that enforcement was considered to be the major role of the regulator. This is of interest as, in the immediately preceding years, there were signs of less stress on the enforcement side of the regulator's role and greater stress on business facilitation.[157] These surveys were placed on an every other year basis, and the next set of reported results were said to show improvements in every area except enforcement.[158] The most recently reported results are said to show improvement in perceived effectiveness in all areas, with the greatest improvements in financial reporting regulation, corporate disclosure more generally, market integration and enforcement of the law.[159]

It is difficult to use these data for the purposes of comparison with the previous regulatory complex under the Co-operative Scheme, of the NCSC and the state and territory CACs. This is not least because those bodies do not appear to have done such surveys of their constituencies. However, the data as reported appear to line up with the indications this Report's authors have been able to glean from their interviews with industry and professional representatives, including some who were opponents of the introduction of National Scheme Version 1. Those indications are of a regulatory enterprise that is seen to be fairly consistently more effective than the Co-operative Scheme complex.[160]

It is clear, however, that the national regulator has used data like these and other user response information in its decision-making about the design of its operations, and other planning for the prioritisation of the use of its resources. Of greatest interest, perhaps, is that the surveys have changed over time, to include questions asking respondents to assess the impact of the regulator's activities on the markets, as well as on the respondents' firms. The first set of results on these new items are reported to have indicated that impact was assessed as very high or quite high by over 50% of respondents in the areas of investment management, prospectuses, investment advice and financial reporting, in that order of magnitude. In reporting those results,

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156 See ASIC, *Annual Report 1997-1998* (1998) at 10 (to then Chairman's knowledge, only regulator in the world to ask systematically those who deal with it to rate performance on a programmatic basis).

157 See on the statutory roles of the regulator the list in the text above, following note 6, and compare ASC, *Annual Report 1990-1991* (1991) at 2, and ASC, *Annual Report 1994-1995* (1995) at 8, with ASC, *Annual Report 1991-1992* (1992) at 2-3; ASC, *Annual Report 1992-1993* (1993) at 4-8; and ASC, *Annual Report 1993-1994* (1994) at 5. The matter is one of *comparative* emphasis in the Chairman's review of the highlights of the year and of the regulator's directions, however.

158 See ASIC, *Annual Report 1997-1998* (1998) at 10 and 23.

159 See ASIC, *Annual Report 1999-2000* (2000) at 1. For a useful short account of the enforcement options available to ASIC, and trends in its use of them, see Australian Law Reform Commission, *Principled Regulation* [:] *Report Federal Civil and Administrative Penalties in Australia* (ALRC Report 95) (Sydney: ALRC, 2002) at 168-171.

160 There are some dissents. One aspect mentioned to us was the way in which the decision to prosecute for offences is seen to be taken with less distance between the investigators and the prosecutors that was associated with the previous complex.

the regulator indicated its plans to reduce some activities and work to better integrate enforcement with market regulation.[161]

These indications line up with the impressions the researchers have gained from their interviews, that the national regulator is well regarded for its responsiveness to user feedback, and at least as much so as the CACs.

There is one area of residual, and continuing, concern, however, as the national regulator has itself acknowledged. It goes to the matter of local service levels, particularly in respect of ready local access to the effective decision-maker, who as explained below will now quite possibly be located elsewhere in Australia.

The authors note that the concerns went to the matters of speed in processing of documentary filings, and of applications for relief, as well as readiness of access to decision-makers for the purposes of conducting negotiations and obtaining usable information. Particular cases mentioned to the authors of this Report included such as the form and content of forecasts in prospectuses and the decision to discontinue a formal investigation. There is no formal published expression of these issues in comprehensive form of which the authors are aware: this listing is of matter which emerges from the authors' interviews for this project and the material supplied to the authors. These anecdotal accounts line up with the information the authors have been able to glean about the performance indicators that ASIC developed and on which it has been reporting on a six monthly basis to all state and territory Ministers under the Corporations Agreements.

It will be recalled that under the two *Corporations Agreements* the national regulator was to establish and maintain a set of performance indicators against which it would report. The form of these obligations has remained constant throughout the two National Schemes. The current arrangements indicate that the regulator has to "maintain" these indicators

> in relation to the levels of service in each referring State and the Northern Territory, and .. monitor and report to each relevant State or Territory Minister on the performance of the Commission against the indicators in the Minister's State or Territory. The frequency of reporting to each such Minister will be as agreed between the Commission and the Minister concerned, but will not be more than twice each calendar year.[162]

The indicators are not published, but it is believed they largely coincide with the national regulator's performance data as these began to be in reported starting in 1992.[163] Those data, by Regional Office, go to such matters as licensees' premises visited as part of surveillance activity; complaints lodged, and investigations begun, with indications of how quickly they were processed; and applications for relief from the law. The corresponding data for more recent years are largely if not entirely in the same categories, but are now reported on a national, not a regional, basis, as will be apparent below.[164] The idea behind the data is that they should in large

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161 ASIC, *Annual Report 1997-1998* (1998) at 24.

162 *Corporations Agreement 2002* (2002), art 603 (2).

163 See ASC, *Annual Report 1991-1992* (1992) at 73ff.

164 See below, table following note 177.

part relate to contact with the public. Reports to the WA Minister are apparently produced at six monthly intervals, and included a narrative on the service being provided locally. In more recent years, there has also been reporting to MINCO on similar matters as part of the presentation by the senior Commissioner from the national regulator who is attending the meeting in question.

In an environment of particularly constrained resources, in the mid-1990s, the regulator noted the "difficult choices" it faced, when organisational consolidation could produce significant cost savings, but National Scheme Version 1's *Corporations Agreement* set minimum service levels in each state and territory at the pre-Scheme levels. The regulator further noted that "even minor [consolidating] adjustments have caused public expressions of concern".[165]

The response to this dilemma has been an increasing measure of re-design of the regulator along the lines of a national and not a regional structure. At the same time considerable efforts have been employed to provide enhanced exchanges between its senior officers and regional constituencies. A number of measures in the latter respect have already been referred to. One measure worthy of mention in both respects is the establishment in the mid-1990s of the National Investor Liaison Committee[166] that by the end of the decade had become the Consumer Advisory Panel, which has already been referred to.[167]

The re-design along the lines of a national and not a regional structure appears to have been very much an evolutionary process, and tends to confirm the literature suggesting there are economies of scale and scope in national rather than local regulation in this area.[168] An initial development was the establishment of the Regulatory Policy Group.[169] It comprised senior ASIC staff, including some Commission members, and included staff based in Brisbane, Sydney and Melbourne. It preceded the appointment of National Directors Enforcement, Regulation and Executive, to assist in coordinating activity in those areas.[170] The stage in the process of re-design described in the most recently published *Annual Report* of ASIC is the arrangements, already referred to, for Executive Directorates headed by a number of Regional Commissioners, with one such Directorate responsible for regional coordination among other matters, and with a new emphasis on the regional facilitation role of the Regional Commissioners. Over this period, there have been other measures to a similar effect, such as the co-location of the two National Offices, in Sydney and Melbourne, with the NSW and Victorian Regional Offices, respectively,[171] as well as the co-location of the Business Centres and the Regional Offices

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165 ASC, *Annual Report 1995-1996* (1996) at 41.

166 The first major reference to which is in ASC, *Annual Report 1996-1997* (1997) at 10.

167 See ASIC, *Annual Report 1998-1999* (1999) at 8 and 59.

168 See the discussion in Whincop (1999), *supra* note 107, who is sceptical, suggesting that if such economies exist, states might confer jurisdiction by their laws on a national regulator. Just such a description could be given of National Scheme Version 1 and National Scheme Version 2, however; and just such a thing appears to have occurred in relation to separate (but now superseded) state regulation of financial institutions: see above, text at note 110.

169 See ASIC, *Annual Report 1997-1998* (1998) at 15, and Policy Statement 51 "Applications for Relief", accessible from http://www.cpd.com.au/newcorp/asic/ps/default.asp (accessed February 28, 2002), para. PS 51.57 (b).

170 See ASC, *Annual Report 1996-1997* (1997) at 57. It should be noted, however, that there had been a National Coordinator for Enforcement from the very early days of National Scheme Version 1.

171 See for Victoria, ASIC, *Annual Report 1998-1999* (1999) at 50; for NSW, ASIC, *Annual Report 1999-2000* (2000) at 46.

nation-wide as part of a move to shift all back office processing from the Business Offices to the Information Processing Centre in Traralgon in Victoria.[172]

These developments have not only been influenced by cost considerations, although these have been significant.[173] There has also been a fairly consistent view that they provide the way to use staff more effectively, through economies of scale and scope in personnel management terms,[174] and through an enhanced ability to plan, mobilise and deploy the resources they represent.[175]

The results the national regulator has to show for its efforts, when considered against the aims the regulator is given by its constating statute,[176] are significant. These results go some way to accounting for the reception the national regulator continues to enjoy notwithstanding the budgetary stringencies to which up until recently it has been subject, the containment in its staff numbers and its movement to a national over a regional structure.

Over the six year period from 1996-1997 to 2001-2002, the national regulator's major public performance indicators show the following[177]:

	2001-02	2000-01	1999-00	1998-99	1997-98	1996-97
Business information						
# reg. coys	1,255,237	1,224, 207	1,195,851	1,149,297	1,088,192	1,026,206
New incs.	90,175	76,103	105,472	98,038	97,031	92,680
Prospectuses lodged	2,089	2,744	1,033	707	683	602
Takeovers	67	81	81	73	76	75
ASIC Performance						
Investigations commenced	246	214	200	207	215	186
Litigation concluded	205	150	173	154	199	178
% successful litigation[178]	92%	71%	75%	89%	90%	84%
ASIC Website browses[179]	6,135,856	4,626,700	3,214,852	n/a	n/a	n/a
% of coy data on time	93%	93%	94%	93%	94%	94%

172 See ASIC, *Annual Report 1999-2000* (2000) at 43.

173 See ASC, *Annual Report 1995-1996* (1996) at 41.

174 ASIC, *Annual Report 2000-2001* (2001) at 56.

175 See ASIC, *Annual Report 2001-2002* (2002) at 5.

176 See above, text at note 6.

177 From See ASIC, *Annual Report 2001-2002* (2002) at 78 (selected data).

178 The table notes that this may understate the success rate in prior years, because of a change to more comprehensive record keeping since then.

179 In March 1997 ASIC launched a facility ("Netsearch") to permit public access to a subset of its on-line data through the internet at its site http://www.asic.gov.au/asic/asic.nsf: see ASIC, *Annual Report 1999-2000* (2000) at 42. This complements the electronic lodgment facility (including an electronic incorporation facility) ASIC now offers.

6. Impact on Australia's Capital Markets

This Section of the Report reviews the impact national companies and securities legislation has had on Australia's capital market, both during the process of nationalization (i.e. federalisation) and after. The evidence and discussion are structured so as to allow Canadian readers to assess how much of the Australian experience may be relevant and instructive for the purposes of the WPC's terms of reference. The Report thus includes some history and description of other developments that were at least as, if not more, influential than the federalisation of securities regulation.

Federalisation is a significant and interesting issue only if there are competing entities below the federal level whose interests are affected. Therefore the question addressed in the first part of this section is whether Australia's capital market consists of regional markets. Evidence of regional capital markets and identification of their distinctive characteristics enable more precise analysis of the impact of federalisation, which is the subject of the second part of the section.

(a) *Does Australia's Capital Market Consist of Regional Markets?*

(i) Background Briefing

Some background knowledge of Australia's physical, demographic and economic geography is helpful to understanding several aspects of its capital markets and how they might relate to the Canadian experience.

Australia occupies a landmass that is 7.6 million square kilometres (i.e. about 82% the size of Canada) and has a population of 19.7 million (i.e. about 62% the population size of Canada). It is a federation of six states and two territories, the Northern Territory and the Australian Capital Territory (ACT).

As Table 1 and Figure 1 show, the population and landmass are unevenly distributed across the States and Territories. Fifty nine percent of the total population lives in two adjacent states, NSW and Victoria, which account for just 13% of the total landmass. When Queensland's population is counted, the Eastern seaboard states contain 78% of the total population and these are heavily concentrated close to the coast and the three state capitals, which are among the oldest European settlements in Australia (Captain Cook first arrived in Australia in 1770).

Apart from mining and agriculture, which contribute just 5% and 4% respectively to gross domestic product (GDP), economic activity is concentrated in the state capital cities which are located far apart, as the distances reported in Table 2 show. Perth, the capital of Western Australia, is about as far away from Sydney – 3,972 kms – as Montreal is from Calgary. However, while Calgary is "just" over 1,000 kms from Vancouver, the closest major city to Perth is Adelaide, which 2,716 kms away.

The above figures point to the fact that the dominant influence on the shaping of Australia's capital markets has been the vast distances between the major economic centres and the relative emptiness between. Remarkably, the vast physical distances separating Australians

in each state are not associated with correspondingly vast differences in economic status or even outlook.

Table 3 reports the average and median weekly household income across the states. Note that in the most isolated state, WA, the household income figures are very close to the national average, while the two territories have weekly household income that lie above the national average and median values. One could even argue that the variation in household income across the states overstates the real difference since housing costs are substantially higher in NSW and Victoria than in Tasmania, the state with the lowest weekly household income. Further, a review of the last two columns of Table 3 shows that the contribution of each state to Australia's Gross Domestic Product matches almost exactly its share of total population.

The above figures are relevant to discussion of Australia's capital markets because they indicate that any problems associated with distance have not proven insuperable in terms of equalizing productivity across the states. The relatively even distribution of wealth across Australia, combined with populations that do not differ greatly across the states (one indicator: there are no readily discernible regional accents), may also have had the result of substantially reducing concerns about the impact of federalising security law. At the very least, relative economic and social homogeneity across the states has not allowed federalisation of securities legislation to become a politically galvanizing issue.

Notwithstanding the lack of strong income disparities across the states,[180] the contribution of various industries to state domestic output varies markedly. This may have an influence on the development of regional capital markets if local knowledge provides a significant advantage in the efficient allocation of capital.

A review of Table 4 shows that finance and insurance and other services contribute over 70% of gross product in NSW, Victoria and the Australian Capital Territory. The mining industry is most dominant in WA and the Northern Territory where it accounts for 21% and 24% of output respectively. Although the share of mining is just 8% of total output in Queensland, it is still four times more than in NSW, Victoria and Tasmania.

Output from the mining industry is mostly exported. WA and the Northern Territory thus supply a disproportionately high value of Australia's exports. In 2001-2, WA, with just 11% of GDP, produced 27% of Australia total merchandise exports and 23.3% of total exports. In the same year, the share of exports of goods and services in gross state product was 45% in Western Australia and 46% in the Northern Territory.[181]

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180 Henceforth, a reference to the states should be taken to include the two territories, unless specifically excluded.

181 Statistics taken from Ernst Juerg Weber, "Monetary Policy in a Heterogenous Monetary Union: The Australian Experience" (Department of Economics, The University of Western Australia working paper, July 2003). The material in the Working Paper was sourced principally from the Australian Bureau of Statistics publications.

(ii) The Australian Stock Exchange: Salient Features and Regional Characteristics

Market capitalization, that is, the total value of issued shares (or stock), is a widely used measure of the size and importance of a stock exchange. By this measure, the Australian Stock Exchange is the 12th largest stock exchange in the world and the Toronto Stock Exchange is the 7th largest. Large investors often prefer to rank exchanges by equity market depth using the Morgan Stanley Capital International (MSCI) indices. The MSCI indices are structured to include a representative spread of liquid stocks across each market. On this basis, the Australian market is ranked ninth in the world and has a weighting of 1.5% on the indices. In comparison, the Canadian market ranks sixth in the world and has a weighting of 2.0%.[182]

In terms of performance, at the end of 2001, the market capitalization of domestic equities on the ASX was approximately A$732.8 billion, an increase from just A$163 billion in 1988-89. The market capitalization for overseas-based equities was A$376.8 billion. Pertinently, there has been a marked shift in the sector profile of the Australian stock market over the last twelve years. As Figure 2 shows, firms from the resources and manufacturing sectors that together accounted for over 70 per cent of market capitalization in 1989 comprised just over 30 per cent in 2001. Service companies, including financial services companies, have filled the gap. Financial services companies now account for nearly 40 per cent of the market, compared to 18 per cent in 1991.

Changes in the structure of the economy explain the increased influence of the services sector on the economy but these changes also make the proportion of total market capitalization accounted for by companies in each state an inappropriate measure of the health of regional capital markets. The evidence shows that across the states, the contribution of each industry to total output varies. If the regional capital markets specialize, it is more appropriate to review each state's participation in the capital market for the industries that are most important to the state. For instance, we have noted that primary product exports, largely from the mining industry, make up 45% of the value of WA's final output yet mining contributes just 5% of the total value of Australia's GDP and its share has been declining relative to the services sector. A review of WA's share of capital market activity as measured by the relative value of its companies is likely to show it to be in decline when in fact the local market may be doing very well in servicing the mining industry.

Table 5 reveals figures consistent with the last proposition. Table 5 shows the number of listed companies that fall in each of 24 (mutually exclusive) ASX industry sectors. Of the 1,347 companies listed on the Exchange, 287 or 21% are classified in the Gold or Other Metals sector. Around 63% of these companies are based or have their headquarters in WA. In short, WA is home to a disproportionately high number of mining companies. The figures are not surprising when one takes into account that WA accounts for a very large share of mining activity and they are consistent with the existence of a specialized regional capital market for mining companies.

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[182] The statistics reported in this and the next paragraph are drawn from Axiss, Australia's Financial Markets Data file, available on www.axiss.com.au. Axiss Australia is an Australian Commonwealth Government agency.

Although one might expect Western Australian companies to dominate the mining sector, the sheer number of Western Australian listed companies is remarkable. Western Australia, with about 10% of the country's population, has 28% of all ASX-listed companies. The number of listed companies based in New South Wales, Victoria and Queensland is about proportionate to their population so Western Australia's over-representation comes at the expense of the other states, as it were. Nevertheless, as expected, given that mining accounts for just 5% of the total value of Australian gross domestic product, the proportion of total market capitalization captured by the WA companies is, at around 6%, far less than their total numbers would indicate (see Table 6). The median market capitalization of the 352 Western Australian companies is just $7.8 million, the smallest median value of all the states and territories by far.

The large number of listed companies in Western Australia is probably explained by the economics of the mining industry. Mining companies, particularly those at the exploration stage, are in essence option-like investments with pay-offs that depend on discovery of viable deposits. This characteristic makes them attractive to investors who seek companies whose value is uncorrelated with the market. Although large companies are also involved in exploration, success is not significantly associated with size and so relatively small companies become viable. Nonetheless, whatever the reason, WA appears to specialize in developing mining companies and so might be said to constitute a regional capital market for this purpose.

Interestingly, neither Queensland nor South Australia, the two other states most comparable in population and size with WA, appears to have a specialized expertise in developing companies in particular industries. However, the percentage of ASX companies headquartered in Queensland is about proportionate to the state's population at 10% but the Queensland based companies' share of total market capitalization is just 3%, reflecting the fact that the bigger (mainly service) companies are based principally in New South Wales and Victoria, the states with the largest populations.

In sum, the data discussed above indicate that while it is meaningful to talk of regional capital markets at least in Queensland and WA, most large scale capital market activity in Australia takes place in Sydney and Melbourne. Queensland and WA arguably function as incubators of companies which access the capital markets in Sydney and Melbourne to achieve national prominence.

The above view might seem unduly dismissive of claims the smaller states might have to possessing independent capital markets. However, there is no strong or obvious evidence that the regions had ever sought to be independent with respect to the capital market.

Australia's vast distances and the lack of substantial population centres between state capital cities have been the key drivers in the development of independent markets. Co-operative efforts between the state-based Stock Exchanges to set uniform broking, methods of dealing and settlements dating as early as 1903 confirm that geography rather than ideology dictated the development of regional capital markets.

(b) *The Impact of Federalisation of Securities Legislation on the Regional Capital Markets*

In reviewing the impact of the 1989 federalisation of securities legislation on the regional capital markets, it is helpful to begin by recalling some points made earlier in this paper.

Prior to 1970, there was limited government involvement in securities regulation in Australia. Allegations of improper trading activities associated with a mining boom in the 1960s prompted the state and federal governments to take a more active role in securities legislation. The subsequent development of the states' securities legislation was an outcome of the lack of a formula to allow federal law to cover securities legislation. It was not a consequence of systematic hostility to federalisation in this area by the states nor was it motivated by explicit recognition of substantive differences across local markets that could not be efficiently addressed with federal legislation. This last point is supported by the formation of the ICAC in 1975, which attempted to coordinate securities legislation across states.

Given the above, the following observations are relevant. Securities regulation legislation was a creature of the 1970s, and the period from 1970 to now has not (until very recently) seen frequent change in securities legislation. Thus federalisation cannot be said to have upset long-established and settled bodies of state-based securities legislation. Further, in-so-far as the states enacted "boiler-plate" (mirrored) securities legislation, they lost any potential efficiency advantages from tailoring regulation to local conditions.

Notwithstanding the above, it is clear as has been noted that in WA at least the prospect of federalisation was viewed with considerable concern. It is worth noting in connection with the capital markets in Perth that Graeme Adamson, the commissioned author of a history of the first 100 years of the Stock Exchange in Perth, was among those concerned. His view, as revealed in the extract from his book below, was that legislation worked best when administered in light of local understandings.

> There are dangers of a loss of identity, and part of this lies in the Hawke Government's proposal of a Canberra-based centralization of the areas presently controlled under the present cooperative scheme through the National Companies and Securities Commission. As Peter Marfleet, the last chairman of the independent Stock Exchange of Perth, noted, isolation has always been a big problem for Perth and, in part, has been responsible for the strong independence of business in the state. If the infrastructure which supports the very distinctive style of business in Western Australia is to be even partly lost, the erosion of independence would change the nature of the share market in Perth. The tendency for company law and securities administration to be centralized threatens that independence and entrepreneurial streak.[183]

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[183] From Graeme Adamson, *Miners and millionaires: The first one hundred years of the people, markets and companies of the Stock Exchange of Perth, 1889-1989* (1989) at 216.

Implicit in Adamson's argument is the assumption that the WA capital market services principally the local individual investor who is more likely to be attuned and sympathetic to "very distinctive style of business in Western Australia". Institutional and non-local investors are more likely to be discomfited by significant differences and be reluctant to invest. In any event, institutional and other non-local investors generally do not invest in companies of the size that predominate in WA and so this supported Adamson's belief that that local investors would be forced to give up the advantages of having an administrative infrastructure that was well adapted to local styles of business in exchange for a federal structure that did not obviously further any party's interests.

(c) *Research Design and Results*

(i) Research Design

An event-study is a commonly used approach in capital markets research to investigate the impact of a given event or development on variables of interest. The variables are measured before and after the event and any difference is attributed to the event, given that the basis for supposing a causal link has been established. The technique relies on large samples to reduce the effect of random variation in the variables being measured and also on establishing controls for other drivers of the variables.

A classical event-study is clearly not feasible in reviewing the impact of federalisation on the West Australian capital market since there are just two events, the first federalisation scheme of 1991 and the second scheme of 2001. Further, other developments in securities markets closely associated in time with one or both of the schemes such as the introduction of screen based trading in 1987, improvements in information technology, and the rise to prominence of fund managers as a result of the Superannuation Guarantee legislation of 1992 that effectively guaranteed large on-going capital inflows into the equity market make it difficult to confidently attribute changes in the capital market to the effects of federalisation.

Given the above, a two-pronged approach has been adopted to investigate the impact of federalisation. One prong is to implement the event-study method and review performance measures of interest before and after federalisation. The results cannot help us determine the specific impact of federalisation since other causal factors are not controlled but they do allow us to at least partially assess whether federalisation was inimical or not to the vigour of the regional markets.

The other prong in our approach is to assess the views of market participants on federalisation. We analyse coverage by the financial media of the issue and also interview leading participants in the capital market in WA to get a sense of how preoccupied, if it all, the capital market was by federalisation.

(ii) Results: Analysis of Trend in IPOs on ASX Pre- and Post-Federalisation

The number of new listings (i.e. initial public offerings or IPOs) on a stock exchange is often viewed as a measure of business confidence because their incidence is correlated with periods when there are high returns to equity capital. Given this point, the rate at which companies based in Western Australia, Queensland and South Australia, sought and obtained a listing on ASX may be interpreted as a barometer of confidence in the regional capital markets. If federalisation were to have an adverse impact on investor confidence, it may be expected to lower the number of listings.

Table 7 shows the number of firms from each state (excluding Tasmania and the two territories) listing on the Australian Stock Exchange over various periods between 1950 through to mid-2003. In addition to the absolute number of listings per state, the table also shows the proportion of total listings over a given period that each state contributes (see columns 2, 4, 6, 8 and 10). The figures are based on the 1,225 ASX firms for which date of listing is available. The total number of firms listed on ASX is around 1400, so the sample is close to comprehensive. Column 12 reports the proportion of all the 1,225 firms which have listed by the year in a given row.

Note, from column 12, that 80% of all the 1,225 firms with listing date information available were first listed from 1986 and onwards. By 1989, the first year of our sample period of interest, just 40% of all present firms were listed. In short, a clear majority of firms listed on ASX have done so post-federalisation. Further, the period since 1989 has been marked in Australia (and elsewhere) by an extraordinary period of growth in the value of equities listed on ASX. At the end of 2001, the market capitalisation of domestic equities on the ASX was about A$732.8 billion, an increase of around 450% from just A$163 billion in 1988-89. Interestingly, ASX Ltd publishes a chart in which it documents the rise in equities value over the past couple of decades and highlights various events, such as the stock market crash of October 1987 and the start of the Australian Federal Government's privatization program. Federalisation of securities legislation is not noted on the chart, which is consistent with the premise that the program did not figure significantly in the minds of investors.

If the period since federalisation has coincided with unprecedented growth in the equities market in Australia, how did the regional capital markets fare? Column 8 of Table 7 shows that the Western Australian contribution to new listings on ASX has been well above what we might expect by considering just the size of its population. Recall that that Western Australians comprise around 10% of Australia's population and its contribution to national GDP is about the same proportion. However, in every year since 1986, Western Australian-based IPOs have comprised well over 10% of all IPOs. Indeed in 2002, after the second phase of federalisation was settled, Western Australian companies contributed 50% of all IPOs on ASX. The market capitalization of these firms was small, as figures discussed earlier indicate; however it remains valid to say that federalisation of securities legislation has not had a negative influence on capital raising in Western Australia, the most remote regional capital market in Australia. The figures for South Australia and Queensland are less impressive but they too indicate that federalisation has not hindered their local capital market.

(iii) Retail Investor Participation in the Share Market

Another measure of confidence in capital markets is the level of retail investor participation. If uncertainty over the federalisation of securities legislation has had the effect of undermining confidence in the share market, we might expect this to be reflected in lower rates of retail (i.e. personal) investor participation.

Statistics on retail investor participation that have been systematically and reliably collected for periods prior to 1989 are difficult to come by, which is a telling indicator in itself about the significance of the level of activity by this class of investor over that period. However, Graeme Adamson has reported that

> statistics showed that, in 1977, just 3.5 percent of Perth people owned shares. By 1989, 14.5 percent of the population owned shares – the highest penetration in Australia and a clear reflection of the difference in market in Perth to that of the eastern states.[184]

In 1997, ASX Ltd conducted the first systematic, large scale survey of share market participation by Australian investors. It revealed there had been remarkable growth in participation since 1989. In 1997, 41% of Australian adults or 5.7 million people owned direct share investments. This increase represented, by any reasonable standard, a dramatic increase in share market participation over the 8 years since federalisation. However, although the start of the dramatic increase coincided almost exactly with the lead-up to National Scheme Version 1 in 1989, it is almost certainly the case that the coincidence is just that. It is difficult to infer a causal link, particularly when there is no commentary or independent reasons in support of a link.

The start of the long bull market in share investments, the increased media attention paid to financial market affairs, the lowering of brokerage commission rates, the greater access to information as a result of the development of the Internet, and, perhaps most importantly in Australia, the privatization via stock market listing of several major institutions all contributed to a continuing surge of interest in investing in the share market.

Interestingly, the information in Figure 3, which shows the incidence of direct share ownership in Australia in 1997 and 2000, reveals that WA no longer has the distinction of being the state with the highest rate of participation in the share market. In 2000, 40% of Western Australians owned shares directly, which is a proportion in line with the rest of Australia. The figure nonetheless represented a significant increase over the 22% of Western Australians who owned shares directly in 1997. However, in its report, ASX Ltd includes the following observations, which suggest the figure of 40% probably overstates the level of active interest in the share market by retail investors: (a) a large proportion of Australian direct investors have received their shares via major floats [attesting to the popularity of the Government's privatization programme], (b) the majority of direct investors are passive investors, (c) 21% of Australians have received shares via floats/gifts etc, (d) half of all direct share owners have only 1 or 2 stocks in their portfolio and have not traded in the past 12 months.

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[184] Adamson, *supra* note 183 at 180.

Notwithstanding the above, the data on retail investor participation in the share market makes clear that federalisation has been entirely compatible with growth in equity market participation by the public. This is true for both the more populous states and those on the periphery.

(iv) Financial Press Coverage of the "Crisis" Caused by the Wakim Case

In 1999, a High Court finding in the *re Wakim*[185] invalidated key sections of the national cross-vesting scheme. Two consequences of this development are pertinent in the context of the present discussion. One is that the High Court's decision provided an opportunity for interests opposed to federalisation to marshal their forces and make any "fix" more difficult to achieve. A review of reaction to the *Wakim* decision therefore provides one means to gauge the extent to which capital market participants in the regional capital markets approved of federalisation. The other consequence of the *Wakim* decision is that it caused greater uncertainty about the enforcement of company law and the effects of this uncertainty can be used to assess how much the sturdiness of the regulatory framework affects capital markets.

The *Australian Financial Review* (AFR) is Australia's premier daily financial newspaper. It is the only financial newspaper covering the whole country and occupies a place in discussion of business affairs that is analogous to that of *The Wall Street Journal* in the US. Coverage of issues in the AFR may therefore be reasonably expected to reflect their relative importance to the business community.

Table 8 lists the title, author(s) and publication date of each of the 57 articles comprising commentary and reports on the *Wakim* case that appeared in the AFR over the three years prior to June 2003. A review of the articles reveals the following salient points, discussed in separate paragraphs below.

None of the articles report or indicate any opposition in principle to the federalisation of securities legislation. Writers spoke of the urgent need to find a solution so that federalisation would be allowed to continue as before the *Wakim* case.

The overwhelming majority of the writers are legal scholars or practitioners (including judges and regulators). Chief executives and others directly involved in business are noticeably under-represented, reflecting perhaps their view that, while the uncertainty was undesirable, a solution would be found in due course. There is a sense that perhaps only the lawyers appreciated the seriousness of the situation.

7. Highlights of the Australian Experience

The Australian experience with the movement from the Co-operative Scheme to National Schemes Version 1 and Version 2 needs to be seen in a larger context. That context is one of relatively little competition between state providers of corporate and especially of securities regulation law over a period even before that of the Co-operative Scheme.[186]

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185 See *supra* note 67.

186 See Whincop (1999), *supra* note 107 at 77, 101.

That may in large part stem from relatively few incentives for relatively few jurisdictions to compete, a situation Australia may share with Canada.[187] In addition, although there are regional distance differences to account for, such as those of concern to residents of WA, there is no region in Australia with the distinctive identity politics of Quebec.

In this context, what may strike outside observers as the relative ease with which Australia transited first into National Scheme Version 1 and then into National Scheme Version 2, and the relative ease with which the national regulator transited away from regional towards national structures, is rather more intelligible that it would be otherwise. These characteristics of the political economy of regulation of corporations and securities regulation law in Australia may also account for the paucity of literature in this country critically examining whether or not something important was lost in the transitions.[188]

Having said that, it also has to be said that the management of the transitions was in the final analysis quite well done, and the results of the transitions have to date been good. There was the undoubted potential for continuing political unease, which might have been fed by user dissatisfaction and business scandal, where both were plausibly attributable to the national regulator, and which could have tainted the enterprises represented by National Schemes Version 1 and Version 2. That potential was not realised. It is also notable that in the most recent and more complete of the two nationalisations they represent, National Scheme Version 2, there are precisely the sorts of review and retreat provisions at the heart of the arrangements[189] that one would expect at the very least if there is a healthy federal polity in Australia.[190] Equally, however, there appears to be a widespread perception that these do not represent a serious risk of the unwinding of the Scheme. The widely shared view is that there will be no withdrawals, and that a continuation of the Scheme in some form beyond its initial term will be achieved. This is in line with the direction towards national arrangements that, as this Report has shown, has been characteristic of Australia's system of corporations and financial products law, at least since the 1960s.[191]

It is further notable that the national regulator has apparently worked hard, and with some effect, to develop arrangements for effective communication with the constituencies, national and regional, that its work affects. There appears to be considerable appreciation of the virtues of these arrangements among those constituencies, although the lowest levels of such appreciation, it must also be said, are to do with the area of regional access to the national decision-makers. There appear to be lessons there for where those decision-makers should be

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[187] See Whincop (1999), *supra* note 107 at 102-103 (noting the contrasts usually made with the US in these respects).

[188] See on this gap the references, *supra* in note 33.

[189] On those provisions, setting a sunset period of 5 years on National Scheme Version 2, see text, above at notes 79 to 81.

[190] On these characteristics, see Whincop (2001), *supra* note 32 at 273.

[191] See Whincop (2001), *supra* note 32 at 273 ("cost of the States unfolding their tents [and returning to state-based regulation] would be prohibitive").

located. The national regulator has traditionally had two "national" offices, in Sydney and Melbourne, but none of its national decision-makers are located outside those two cities and the capital of the state of Queensland, Brisbane. It may be that there is scope without excessive efficiency loss to generalise the lesson of the dual national offices. It is true that travel, and virtual interchanges, can help to make up for the huge and empty distances involved in national regulation in Australia that are another feature it shares with Canada if to a greater extent in this country. However, there is considerable reason to think that these forms of communication at a distance are simply not full substitutes for those made possible by local location.[192]

It is also important to note that, while National Scheme Version 1 and National Scheme Version 2 were both improvements on their predecessor, none of this is of course a case to show that either was the *optimal* set of arrangements, in economic or in political terms.[193] A number of different models might be fairly readily suggested, on the former (economic) if not the latter (political) account. One such model might involve, in the area of securities regulation, a *mix* of federal and state regulation – if *not* the mix characteristic of the US,[194] or Canada currently.

At the level of impact of the National Schemes on Australia's capital markets, federalisation of securities legislation is only one of several significant developments in the Australian capital market over the past couple of decades.

Changes in information technology, deregulation of the financial services sector, structural changes to the economy that have dramatically increased the total and relative contribution of the service sector to GDP, the introduction of competition policy, introduction of the compulsory contribution-based retirement savings scheme in July 1992 and the concomitant growth of the superannuation funds management industry have been the other major forces shaping the Australian capital market from around 1975.

In terms of this Report, the developments have had two effects: (a) they have all contributed to consolidation (in effect, centralization) and expansion of the Australian capital markets, and (b) they have reduced the federalisation of securities legislation as an issue of concern among market participants.

Federalisation and the other developments have reduced the relative importance of the regional capital markets but not necessarily their level of activity. The national market has grown

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192 For a similar point with references for physical meetings of shareholders over substitutional electronic ones, see Ralph Simmonds, "Why must we meet? Thinking about why shareholders meetings are required" (2001) 19 Company and Securities L.J. 506.

193 This was in fact conceded in a number of the interviews the authors conducted. It was noted, for example, that there was no public review in Australia of alternative models for the structure of corporate law and securities regulation, let alone public debate about appropriate "evaluative criteria" for such models, of the sort that the interviewees associated with the Canadian WPC exercise. Compare the discussion of the run-up to that exercise in Harris (CBLJ), *supra* note 8. The academic literature in Australia has appeared only recently to have begun to address these issues in a systematic way: see the reference in note 194, below.

194 See the working out of just such a set of arrangements in Whincop (1999), *supra* note 107 at 105-111; but see also 119:

> I would be the first to acknowledge that the proposed metareform of corporate [and securities regulation] law is improbable. There may be substantial criticism of the Corporations Law from time to time, but that criticism is not complemented by a push towards state competition.

dramatically over the last two decades but the regional markets have also recorded impressive growth. Indicators of capital formation such as individual investor participation and the incidence of newly listed companies headquartered in cities outside of Sydney and Melbourne have improved on pre-federalisation figures.

The authors would agree that there is a sense among some market actors in Australia that this country has seen issuers suffer from the disappearance of the "second boards" (specialized exchange facilities, including listing rules, for more speculative or junior issuers) here. However, market actors do not appear to associate this so much with national governmental regulation as with the emergence of a national exchange, the ASX, to replace all of the state based ones. Further, specialized exchanges have begun to re-emerge. Further, the authors note the disproportionate representation of WA listed issuers on the ASX, as indicated in this Report.[195]

It might be expected that the uncertainty occasioned by the constitutionally unwieldy process of federalising what was previously state-based legislation would have had a negative impact on capital markets. The public records do not indicate this to be case.

Four factors may explain the apparent equanimity of the markets. (a) The other developments identified above could have overwhelmed the uncertainty associated with federalisation. (b) The process of federalising securities legislation was unwieldy but market participants expected it to continue and succeed. (c) The consequences of not finding solutions to the problems posed by the *Hughes* and *Wakim* cases to federalisation of securities legislation were of such gravity that it was probably considered highly unlikely they would not be found. (d) The specific constitutional flaws identified by the *Hughes* and *Wakim* cases assumed importance only in extreme cases. Capital raisings and normal company business are not usually predicated on extreme scenarios.

In short, while federalisation of securities legislation has involved a highly complex and drawn-out legal process, the impact on Australian capital markets has not been correspondingly fraught. On the whole, the evidence is consistent with federalisation improving the efficiency of the Australian capital market. The national market has grown in size and the regional markets have not suffered in absolute terms.

By way of overall conclusion on the Australian experience for a Canadian audience, this needs to be said. It might be suggested (and one submission to the Committee did say) "[i]f Australia – a country of similar size and political complexity to Canada – can establish a single securities regulator, then surely Canada ought to be able to do so as well". However, this Report is meant to emphasise that whether or not national regulation emerges, and the form in which it emerges, are as much a matter of felt political necessities and possibilities as any other matters.

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195 The Canadian Listed Company Association asserted in its submission to the Committee that "the centralization of the Australian securities regulatory system ... ended their speculative mining market and in the late eighties and early nineties we saw dozens of Australian companies listing in Canada because there wasn't an active liquid market there." (Canadian Listed Company Association, submission to WPC). We disagree with this assertion for the reasons provided in the paragraph accompanying this note.

The Australian experience, we have concluded, tends to show that the size and political complexity of the jurisdiction in issue are factors, but not necessarily decisive ones, in the process. The authors would add that there are points of difference in the geography of and forms of political complexity between Australia and Canada that need to be taken account of in considering the lessons of the one for the other. That said, the Australian experience shows the *potential* for national securities regulation in a federation like Canada, no more and no less.

Table 1
Distribution of landmass and population across the six Australian states and two territories

	Area '000 sq kms	Percent of total landmass	Population '000s	Percent of total population	State Capital City	State Capital Population '000s
NSW	800.6	10%	6,609	34%	Sydney	4,155
Vic	227.4	3%	4,823	25%	Melbourne	3,489
Qld	1,730.6	23%	3,635	19%	Brisbane	1,653
SA	983.4	13%	1,515	8%	Adelaide	1,111
WA	2,529.8	33%	1,906	10%	Perth	1,397
Tas	68.4	1%	473	2%	Hobart	1,98
NT	1,349.1	18%	200	1%	Darwin	1,08
ACT	2.3	0.03%	322	2%	Canberra	3,21
Australia	7,691.9		19,483			12,432

Abbreviations:

NSW - New South Wales; **Vic** - Victoria; **Qld** - Queensland; **SA** - South Australia; **WA** - Western Australia; **NT** - Northern Territory; **ACT** -Australian Capital Territory.

Source: *Australian Bureau of Statistics (2000-1 census)*

Figure 1
Remoteness Areas across Australia – 2001

Source: *Australian Social Trends 2003, ABS 4102.0 (p.8)*

Table 2
Road distances (kilometres) between State capitals in Australia

Road Distances	Adelaide	Brisbane	Canberra	Darwin	**Melbourne**	Perth	**Sydney**
Adelaide	-	2,055	1,198	3,051	732	2,716	1,415
Brisbane	2,055	-	1,246	3,429	1,671	4,289	982
Canberra	11,98	1,246	-	4,003	658	3,741	309
Darwin	3,051	3,429	4,003	-	3,189	4,049	4,01
Melbourne	732	1,671	658	3,789	-	3,456	873
Perth	2,716	4,363	3,741	4,049	**3,456**	-	**3,972**
Sydney	1,415	982	309	4,301	873	3,972	-

Table 3
Selected statistics on household income and state domestic product

State	Capital City	Mean weekly household income	Median weekly household income	Total State Domestic Product $m	SDP as percent of GDP	State share of total population
NSW	Sydney	$1,191	$949	$243,171	35%	34%
Vic	Melbourne	$1,049	$846	$179,369	26%	25%
Qld	Brisbane	$928	$787	$115,530	17%	19%
SA	Adelaide	$856	$731	$45,765	7%	8%
WA	Perth	$1,033	$842	$77,495	11%	10%
Tas	Hobart	$796	$652	$11,976	2%	2%
NT	Darwin	$1,353	$1,180	$9,061	1%	1%
ACT	Canberra	$1,275	$1,150	$13,928	2%	2%
Australia		$1,082	$880	$695,663	100%	100%

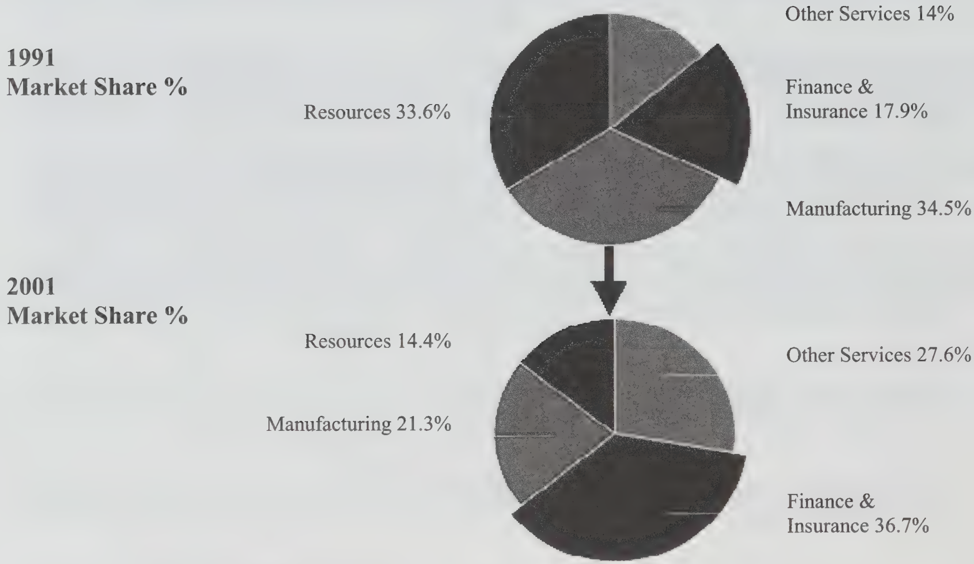
Source: *Australian Bureau of Statistics (2000-1 census)*

Table 4
Industry contribution to gross product in each state, 2001-2

Sector	NSW	Vic	Qld	**WA**	SA	Tas	NT	ACT	*Aust*
	%	%	%	%	%	%	%	%	%
Manufacturing	12	14	10	9	14	14	4	2	12
Agriculture, forestry and fishing	3	4	5	4	8	6	4	—	4
Mining	2	2	8	**21**	3	2	**24**	—	5
Finance & insurance services	9	8	5	4	6	6	3	4	7
Other services	66	63	63	52	61	61	57	84	
Other	8	9	9	10	8	11	8	10	
Total	100	100	100	100	100	100	100	100	

Source: *Australian Bureau of Statistics 5220.0*

Figure 2
Stock Market Capitalization by Industry Sector



Source : Australian Stock Exchange

Graphic sourced from Axiss Australia's Financial Markets Data file.

Table 5
Distribution of ASX-listed companies across states and industries, June 2003

The number in each state is expressed as a percentage of the total number of companies in each ASX industry sector description. The numbers include 104 suspended companies.

Industry Sector	No of Cos	NSW	Vic	Qld	WA	SA	Tas	NT
Miscellaneous Industrials	**240**	40%	23%	10%	22%	5%	1%	
Invest. and Fin. Services	**165**	41%	31%	11%	14%	3%	1%	
Gold	**161**	16%	12%	7%	**63%**	1%		1%
Other Metals	**126**	17%	10%	6%	**62%**	3%	1%	
Healthcare and Biotech	**97**	35%	35%	8%	18%	4%		
Energy	**72**	33%	17%	14%	31%	6%		
Telecommunications	**72**	31%	26%	6%	36%	1%		
Media	**54**	52%	30%	7%	11%			
Property Trusts	**50**	78%	6%	6%	10%			
Retail	**46**	43%	20%	11%	22%	4%		
Tourism and Leisure	**39**	44%	15%	31%	8%	3%		
Developers and Contractors	**36**	22%	22%	28%	25%	3%		
Food and Household	**30**	23%	37%	17%	20%		3%	
Infrastructure and Utilities	**29**	38%	31%	10%	17%	3%		
Engineering	**25**	28%	24%	8%	32%	8%		
Diversified Industrials	**24**	25%	29%	8%	33%	4%		
Building Materials	**22**	50%	14%	9%	14%	9%	5%	
Banks and Finance	**16**	25%	19%	31%	13%	13%		
Alcohol and Tobacco	**10**	30%	20%	10%		40%		
Transport	**10**	30%	40%	10%	20%			
Diversified Resources	**7**	29%	57%		14%			
Paper and Packaging	**7**	14%	71%				14%	
Insurance	**6**	83%	17%					
Chemicals	**3**		100%					
Total All Sectors	**1,347**	**463**	**302**	**140**	**387**	**47**	**7**	**1**
% of all companies		**34%**	**22%**	**10%**	**29%**	**3%**	**1%**	

Source: *Aspect DatAnalysis from Aspect Financial Pty Ltd Aspect, June 2003*

Table 6
Distribution across states of the head-offices of ASX-listed companies and summary statistics on the market value of companies in each state, June 2003

Market capitalization expressed in Aus $millions. Suspended companies are excluded.

	WA	NSW	Vic	Qld	SA	ACT	Tas	NT	All
No. Trading	352	430	277	134	42	5	7	1	1248
% of Total	28.2%	34.5%	22.2%	10.7%	3.4%	0.4%	0.6%	0.1%	
Mkt.Cap									
Average	109.35	761.71	924.72	150.31	240.72	19.26	169.57		523.75
Median	7.8	37.2	28.8	21.4	19.9	16.1	41.0		
Maximum	10,027.15	37,532	49,468.0	6,528.6	3,558.3	41.6	995.3	38.9	49,468.0
Minimum	0.76	0.35	0.08	0.89	2.1	3.4	2.2		0.08
Total MktCap	38,381.24	327,533.44	256,148.38	20,141.67	10,110.11	96.32	1,187.00	38.93	653,637.09
% of Total MktCap	5.87%	50.11%	39.19%	3.08%	1.55%	0.01%	0.18%	0.01%	100.00%

Source: *Aspect DatAnalysis from Aspect Financial Pty Ltd Aspect, June 2003*

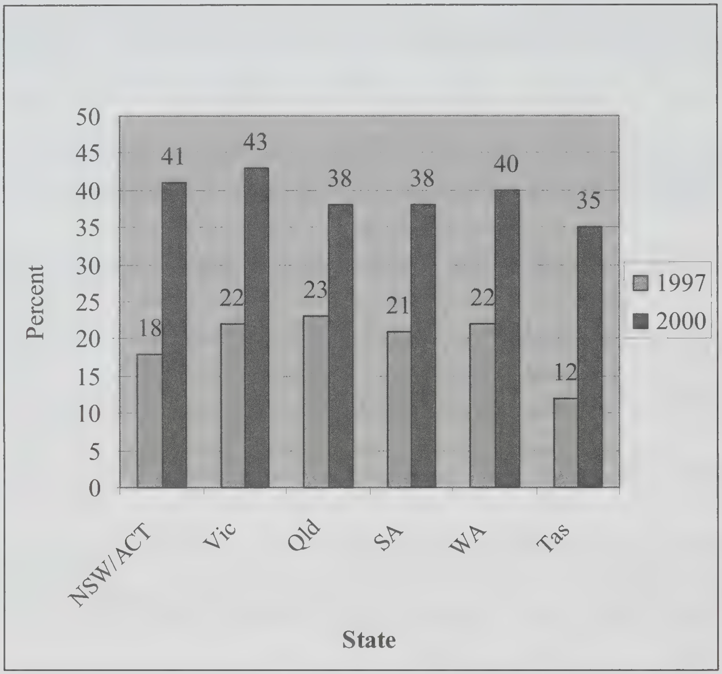
Table 7
Number of firms listing on the Australian Stock Exchange each year, sorted by the State in which their headquarters are located.

The odd numbered columns from 1 to 11 include the number listing in each year. From 1985 onwards, the information is presented on a yearly basis. The even columns from 2 to 10 express the number of listings in each state as a percentage of the total listings. Total listings are shown in column 11. Column 12 reports the cumulative listings over time expressed in percentage terms. Listing date information for firms delisted prior to 1997 is not available.

	NSW		Vic		Qld		WA		SA		All States	
	1	2	3	4	5	6	7	8	9	10	11	12
Year	No.	%	No.	%	No.	%	No.	%	No.	%	No	Cumulative %
1950	5	56%	2	22%	0	0%	2	22%	0	0%	9	1%
1970	30	45%	14	21%	4	6%	16	24%	3	4%	67	6%
1980	30	37%	12	15%	11	14%	21	26%	7	9%	81	13%
1985	26	28%	14	15%	5	5%	44	48%	3	3%	92	20%
1986	21	29%	9	12%	7	10%	34	47%	2	3%	73	26%
1987	30	26%	17	15%	6	5%	58	50%	4	3%	115	36%
1988	5	23%	4	18%	5	23%	8	36%	0	0%	22	37%
1989	10	37%	7	26%	5	19%	5	19%	0	0%	27	40%
1990	6	33%	2	11%	1	6%	8	44%	1	6%	18	41%
1991	8	28%	5	17%	1	3%	14	48%	1	3%	29	44%
1992	9	26%	4	12%	5	15%	14	41%	2	6%	34	46%
1993	21	28%	11	14%	12	16%	29	38%	3	4%	76	52%
1994	20	24%	19	23%	4	5%	35	43%	4	5%	82	59%
1995	8	31%	8	31%	3	12%	5	19%	2	8%	26	61%
1996	15	32%	10	21%	3	6%	17	36%	2	4%	47	65%
1997	19	35%	13	24%	5	9%	16	29%	2	4%	55	70%
1998	16	39%	11	27%	1	2%	11	27%	2	5%	41	73%
1999	36	47%	11	14%	7	9%	19	25%	4	5%	77	79%
2000	37	31%	26	21%	9	7%	46	38%	3	2%	121	89%
2001	12	22%	9	17%	10	19%	23	43%	0	0%	54	94%
2002	18	29%	8	13%	2	3%	31	50%	3	5%	62	99%
2003	2	12%	4	24%	2	12%	8	47%	1	6%	17	100%
Total	**384**	**31%**	**220**	**18%**	**108**	**9%**	**464**	**38%**	**49**	**4%**	**1225**	

Source: *Aspect DatAnalysis from Aspect Financial Pty Ltd Aspect, June 2003*

Figure 3
Incidence of direct share-ownership by state in 1997 & 2000, expressed as a percentage of the adult population in each state



Source: *ASX 2000 Share ownership study, 2000*

Table 8
List of 57 articles appearing in the Australian Financial Review over the five years preceding June 2003 that include a reference to the "Wakim case"

No	Headline	Author(s)	Word Length	Date Published
1	Fast Legislative Action Needed On Wakim	Prof Bob Baxt, Paul Meadows And Sam Cadman of Arthur Robinson & Hedderwicks	939	18 June 1999
2	High Court Puts Ball In The States' Court	Andrew Burrell & Mark Drummond	640	18 June 1999
3	Federal Court Canberra At Odds	Aaron Patrick And Andrew Burrell	700	23 July 1999
4	No Doubts In Wakim Wake	Justices G.F.K Santow R Austin	773	26 July 1999
5	Jurisdictional Deadlock Looms After Wakim	Jeff Shaw NSW Attorney-General	837	30 July 1999
6	Good Governance And Competition Go Hand In Hand	Ian Dunlop Chief Executive Officer of The Australian Institute of Company Directors	1064	10 August 1999
7	High Time For Some Action	Prof Bob Baxt And Edward Archibald (law student)	570	13 August 1999
8	Remedial Laws Face Challenge	John Breusch	505	27 August 1999
9	Time To End The Legal Impasse		747	1 October 1999
10	Referendum Proposed For A National Courts System	Andrew Burrell	520	15 Nov 1999
11	Bell Group Case Stalls After High Court Ruling	Mark Drummond	521	22 Nov 1999
12	Stating SA's Strong Concerns		211	29 Nov 1999
13	Gutnick Pops A Cork As Court Delivers Huge Win	Nicholas Reece & Andrew Burrell	427	11 Dec 1999
14	The Jockey Breaks His Long Silence On Moage Affair	Trevor Sykes	1951	25 Jan 2000
15	Unmaking A Federal Case Out Of It	Nicholas Reece	836	4 Feb 2000
16	Federal Court Cases `dry Up'	Andrew Burrell	254	3 March 2000
17	Bond Case Highlights Need For Legal Shake-up		642	11 March 2000
18	Bell Liquidator Given Push Over Conflict Of Interest	Mark Drummond	330	20 March 2000
19	Chanticleer	John Durie	474	23 March 2000
20	A-G Rules Out Referendum On Company Law	Chris Merritt	373	24 March 2000

No	Headline	Author(s)	Word Length	Date Published
21	Attorney-General Stuck For Solution On Corporation Law Status	Chris Merritt	522	24 March 2000
22	Fixing The Mess That Is Corporations Law	Katharine Murphy & Tony Harris	547	7 April 2000
23	Rebel States Block Vital National Reform	Chris Merritt	1937	7 April 2000
24	This Law's Condition Is Critical Warns Regulator	Alan Cameron, Chairman of The Australian Securities And Investments Commission	998	7 April 2000
25	SA And WA Unfairly Accused	K T. Griffin & P. Foss, Attorneys-General, South Australia & Western Australia	376	17 April 2000
26	Hughes Decision Heightens Uncertainty	Dr George Williams, Barrister And Senior Lecturer	1054	5 May 2000
27	Legal Mess Must Be Cleaned Up As Soon As Possible	Ian Dunlop Is Chief Executive Officer of The Australian Institute of Company Directors	949	5 May 2000
28	Action Needed To End Legal Uncertainty For Business	Daryl Williams, Commonwealth Attorney-General	693	5 May 2000
29	Law Council Supports Federal Solution	Chris Merritt	188	5 May 2000
30	Business Paying Taxes Disguised As Fees	Tony Harris	1036	19 May 2000
31	Co-operative Schemes Of Governments Must Prevail	Jan Wade, Visiting Professor at Victoria University	722	26 May 2000
32	Black View Of Corporate Regulation Crisis	Katherine Towers	476	23 June 2000
33	Black-letter Law Leaves A Nasty Mess On The Floor	Chris Merritt	369	26 July 2000
34	Corporations Law Fix Temporary	Judge Katherine Towers	579	27 July 2000
35	News Battling With The Law	Trevor Sykes	1811	13 August 2000
36	Referral Of Corporate Powers Urgent	Alison Lansley, Chair of The Securities Institute's Markets Policy Group	935	18 August 2000
37	Modest Proposal To Fix Corporations Law	Dennis Rose QC & Geoffrey Lindell	629	22 August 2000
38	Getting Down To Business Law	Editorial	758	25 August 2000
39	States' Free Dividends May Cease	Tony Harris	277	25 August 2000
40	Five Options For The Corporations Law	Jan Wade		25 August 2000

No	Headline	Author(s)	Word Length	Date Published
41	Prosecutions Could Face Axe	Chris Merritt	482	25 August 2000
42	A Vote Needed On Business Law	Editorial	748	1 Sept 2000
43	Companies Law Deal Hailed As Workable	Cherelle Murphy	514	20 Oct 2000
44	Details Hazy On FSR Self-regulation	John Breusch	377	3 Nov 2000
45	Challenges Ahead For Corporations Law	Bruce Walkley	690	17 Nov 2000
46	Getting Down To Business	Editorial	744	3 Jan 2001
47	Corporations Law Claim `not Correct'	K. Trevor Griffin, State Attorney General, South Australia	361	11 Jan 2001
48	New Scheme Will Give Certainty	Rob Hulls	577	19 Jan 2001
49	Gutnick Case Returns To Federal Court	Katherine Towers	179	9 Feb 2001
50	Federal Court's Doors Open Again	Bill Pheasant	637	16 Feb 2001
51	Breakthrough On Corporations Law	Joyce Moullakis	347	24 March 2001
52	Federation's Endless Juggling Act	Prof Bob Baxt & Julie Smith, Julie is a Research Fellow at The Australia Institute	1219	10 May 2001
53	Companies Law Sequel Fits The Bill Admirably	Alan Cameron	949	11 May 2001
54	Chief Justice Defends HIH Appointment	Cathy Bolt	830	29 June 2001
55	Companies Law Back On Track	Daryl Williams, Federal Attorney-General	623	29 June 2001
56	Williams To Challenge `fix' To Law	Bill Pheasant	381	23 July 2001
57	Federal Judges Woo Corporate Law Cases	Katherine Towers	417	24 July 2001

Source: *Archives of the Australian Financial Review and Factiva*

Table 9
Fiscal Significance of the Compensation for the National Schemes
Version 1 and Version 2

Estimates (in $ millions) of the compensation the Australian Federal Government has paid/will pay to the six States and Northern Territory for revenue forgone following commencement of the national scheme for the regulation of companies and securities. The revenue was just under half a percent (0.45%) of all net payments to the States by the Federal Government in 1991-1992, the first full year the scheme was in operation. By 2001, the proportion had dropped to 0.28%. The payments are classified as "specific purpose payments" and are one of the very few payments of this type that have no conditions placed on their expenditure.

Panel A – Fiscal Years Ending 30 June 1991 through to 30 June 97

	1990-91	**1991-92**	**1992-93**	**1993-94**	**1994-95**	**1995-96**	**1996-97**
NSW	22.9	38.6	39.3	41.3	40.7	42.0	43.3
VIC	19.7	33.7	34.3	36.5	35.6	36.7	37.9
QLD	10.9	19.0	19.3	20.2	20.1	20.7	21.3
WA	6.9	11.7	11.9	12.5	12.3	12.7	13.1
SA	5.1	8.7	8.9	9.3	9.2	9.5	9.8
TAS	1.6	2.7	2.7	2.9	2.8	2.9	3.0
NT	1.0	1.7	1.7	1.8	1.8	1.9	1.9
Total	**68.0**	**116.1**	**118.2**	**124.3**	**122.6**	**126.4**	**130.3**

Panel B – Fiscal Years Ending 30 June 1998 through to 30 June 2004

	1997-98	**1998-99**	**1999-00**	**2000-01**	**2001-02**	**2002-03**	**2003-04**
NSW	44.0	44.8	44.8	46.3	49.1	50.4	52.3
VIC	38.5	39.2	39.2	40.5	43.0	44.1	45.8
QLD	21.7	22.1	22.1	22.8	24.2	24.8	25.8
WA	13.3	13.6	13.6	14.0	14.9	15.3	15.9
SA	9.9	10.1	10.1	10.4	11.1	11.4	11.8
TAS	3.1	3.1	3.1	3.2	3.4	3.5	3.7
NT	2.0	2.0	2.0	2.1	2.2	2.2	2.3
Total	**132.6**	**134.8**	**134.9**	**139.3**	**147.9**	**151.8**	**157.5**

Source: *Australian Federal Budget Papers (Budget Paper no 3) from 1991 to 2002*

Local and Regional Interests in the Debate on Optimal Securities Regulatory Structure

Research Study Prepared for the
Wise Persons' Committee

Poonam Puri

October 7, 2003

Local and Regional Interests in the Debate on Optimal Securities Regulatory Structure

Biography

Poonam Puri

Poonam Puri is an Associate Professor of Law at Osgoode Hall Law School, York University. She is a graduate of the University of Toronto Faculty of Law (LL.B. Silver Medalist) and Harvard Law School (LL.M.). She articled at Torys and was a summer associate at Paul, Weiss, Rifkind Wharton and Garrison in New York. Professor Puri's research expertise is in corporate governance, corporate law, securities law, corporate and white-collar crime, bankruptcy law, and law and economics. Professor Puri was recently a Visiting Professor at Cornell Law School and recipient of the Osgoode Hall Law School Teaching Award.

Local and Regional Interests in the Debate on Optimal Securities Regulatory Structure

Executive Summary

In considering optimal securities regulatory structure, it is important to determine whether distinctive local and regional capital markets exist. If so, they should be taken into account.

A capital market is comprised of issuers and investors. In respect of issuers, this study finds that local infrastructures for capital raising (LICRs) exist for certain industries and levels of market capitalization. An LICR is defined as a geographic region where there is a critical mass of issuers of a certain industry type or level of market capitalization; this allows local securities regulators and professionals (such as investment bankers, lawyers and accountants) to develop an expertise and respond to the needs of such issuers.

This study finds that Alberta hosts an LICR for oil and gas, B.C. hosts an LICR for micro-cap issuers, and Ontario hosts an LICR for financial services. Certain LICRs exist in more than one province: Both B.C. and Ontario host LICRs for mining; Ontario, Quebec and B.C. for communications and media; Ontario and Quebec for life sciences; and B.C., Alberta and Ontario each host an LICR for small cap issuers.

However, the existence of LICRs for certain industries does not allow us to conclude that the economic activity associated with these industries is local to host provinces or that host provinces have distinct local interests in the capital markets regulation or general regulation of those industries.

The activities of issuers concentrated within an LICR have an impact outside the geographic boundaries of the province that hosts and regulates the LICR. Other provinces may have an interest equal to that of the regulating province, given investor location and the importance of those industries to the economies of other provinces, as borne out by Gross Domestic Product (GDP) data.

Having found that LICRs for certain industries and levels of market capitalization exist in Canada, the issue that follows is whether provincial securities commissions that host an LICR identified in this study are responsive to that infrastructure in a manner that is different than other provincial securities commissions that do not host that LICR.

Factors for determining whether a locally-developed policy is a response to distinctive local interests include the following:

- Was the creation of the local policy followed by multilateral or national adoption by other provincial regulators? If so, then the local policy may be an example of regulatory innovation supporting an argument for regulatory experimentation, but not an argument for local regulation of distinct local markets.

- Was the local policy created for the purpose of supporting an industry that is local to the province? If other provinces do not host the relevant industry in their geographical boundaries and are not interested in its development, then the local policy likely responds to a distinct local market.

- Is the local policy's application limited to issuers and investors that are all within the province? If investors are not located within the same province as the issuers to whom the policy applies, the local policy is not likely responding to a distinct local market. However, the fact that issuers and investors may be located in the same province is not determinative of whether the policy responds to distinctive local interests.

- Can the underlying rationale of an industry-specific local policy be reasonably generalized such that its stated purpose is to allow issuers to raise capital with ease and without the costs associated with preparing a prospectus? If so, then the local interest loses its distinctiveness and the necessity for a local policy may be questionable; a more general national policy that is not industry-specific may serve the local interests.

The Saskatchewan Community Venture Local Policy may be a legitimate example of a local policy serving distinct local needs and hence, supports the importance of provincial regulation of distinctive local and regional markets.

However, most locally-developed policies and regulatory approaches examined in this study have experienced relatively rapid multilateral or national adoption. In addition, most locally-developed policies studied in this report have been (a) in relation to industries that are national, not local, in character; (b) in response to concerns that are common to investors throughout the country; and (c) industry-neutral rules that allow issuers to raise capital in a cost-effective manner.

Overall, the analysis in this study finds that most local regulatory responsiveness is not the product of local and regional distinctiveness. As a result, the main conclusion to be drawn from the study is that existing local and regional differences can be accommodated under different regulatory models without appreciable differences in regulatory outcomes.

This does not amount to an assertion that, in considering alternatives to the current regulatory structure, local regulatory expertise should not be preserved. A uniform securities law model and a passport model would allow for existing regulatory expertise to be maintained within existing local regulatory commissions. A single regulator (whether a model based on provincial delegation or federal action) could, if properly designed (for example, along industry lines and/or with regional offices) maintain existing expertise. To the extent that an LICR does not exist for certain industries and as a result, no one local regulator currently has expertise, a single regulator would allow for a consolidation of scattered expertise.

Local and Regional Interests in the Debate on Optimal Securities Regulatory Structure

1. Introduction

In the long-standing debate on reform of the securities regulatory framework in Canada, the issue of local and regional markets and the concerns of local market regulators have always been at the forefront of the discussion. What is surprising is that while both proponents and critics of securities regulatory reform hold deeply entrenched views on the topic of local and regional interests, little rigorous analysis has been conducted of the topic and the underlying issues.

Critics have stated that a national securities commission would not be able to regulate effectively local and regional markets and would not take into account local and regional issues, priorities and interests.[1]

Other commentators, however, have questioned why a national regulator could not be structured to take regional differences into account.[2]

In the 2002 White Paper released by the Capital Markets Institute entitled "A Symposium on Canadian Securities Regulation: Harmonization or Nationalization?", Professor Doug Harris identifies the important role that accommodating local and regional interests plays in the debate on Canada's securities regulatory structure.[3] He states:

> We need a comprehensive study of the role of local and regional interests in the structure of securities regulation in Canada, the extent to which there are geographically segmented capital markets in Canada, the costs and benefits of such segmentation for the Canadian capital market as a whole, and the role that decentralized securities regulation plays in shaping those costs and benefits. It is only on the basis of this kind of data that the debate can move beyond the unhelpful geographical generalizations that have characterized it to date.[4]

The following analysis attempts to fill this research gap such that stakeholders can engage in a more meaningful debate and so that proposals for reform can be analyzed on a more solid theoretical and empirical foundation.

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1 See, for example, Stephen Sibold's comments at http://www.rotman.utoronto.ca/cmi/march8.doc and Doug Hyndman's comments at http://www.rotman.utoronto.ca/cmi/news/Hyndman.doc.

2 See, for example, Anita Anand, "Harmonizing Canadian Securities Laws: Considering Alternatives" in *Globalization: Proceedings of the 8th Queen's Annual Business Law Symposium* (2001).

3 A. Douglas Harris, *A Symposium on Canadian Securities Regulation: Harmonization or Nationalization? White Paper* (2002).

4 *Ibid* at iv.

The objectives of this research study are two-fold. This study first examines the extent to which distinct local and regional capital markets exist in Canada. Second, it considers whether those markets, to the extent they exist, are best regulated on a local or regional basis.

Part 2 examines whether distinct local capital markets exist in Canada. Two primary sets of data are analyzed. First, an analysis is conducted of reporting issuers listed on the Toronto Stock Exchange (TSX) and the TSX Venture Exchange by province, industry type, and market capitalization. Second, GDP by province and industry is analyzed to assess the economic importance of various industries to regions in Canada.

Part 3 assesses whether provincial regulators have developed levels and forms of regulation that have been responsive to the needs of LICRs located within their province. Part 3 concludes by analyzing the relationship of these local regulatory responses to the issue of distinctive local markets and their impact on analyzing optimal regulatory structure.

Part 4 highlights other developments in the Canadian capital markets that are relevant to the debate on local and regional interests.

Part 5 highlights how the securities regulatory structure of the United States addresses local markets and interests.

Part 6 concludes with comments on the weight and significance that ought to be given to local and regional issues in analyzing optimal securities regulatory structure for Canada.

2. Analysis of Local and Regional Capital Markets

In the context of the debate on local and regional markets, the following broad generalizations are often made:

- Alberta has a local market in oil and gas;
- Alberta and B.C. have local markets that focus on micro- and small-cap issuers;
- B.C. has a local market in mining and is known for attracting technology issuers; and
- Ontario has a local market for financial services.

This part of the study tests the validity of these particular assertions, and analyzes whether distinct local markets exist in Canada by (a) examining issuer data; (b) discussing investor location; and (c) conducting an analysis of GDP figures classified by province.

As Professor Harris has pointed out:

> If local and regional flexibility is proven by an empirical study to be critical to the development of businesses that will make Canada globally competitive in the future, then the fact that a federal securities regulator does not offer a clear way to provide it may prove to be determinative against that proposal. If, on the other hand, local and regional flexibility

is found to be a red herring, the relative strengths and weaknesses of the various reform proposals would have to be reassessed on a fundamental level.[5]

An analysis is first conducted of reporting issuers listed on the TSX and the TSX Venture Exchange by industry type and by the province in which the issuer's head office is located. The location of an issuer's head office will generally indicate which province's or territory's securities commission is the principal regulator under the Mutual Reliance Review System (MRRS).[6]

To the extent that there is a critical mass of industry or sector specific issuers in a geographical region, there will likely be a development of expertise over time within the securities commission in that geographic area. There will also be a clustering of professionals such as securities lawyers, accountants and investment bankers that service these issuers and develop an expertise in the industry. In this study, I label this phenomenon as a "local infrastructure for capital raising."[7]

In assessing whether an LICR exists for any particular industry, I have analyzed the data from four perspectives for each province and industry:

1. The number of issuers headquartered in a province as a percentage of the total number of issuers in that industry;

2. The number of issuers headquartered in a province as a percentage of the total number of issuers principally regulated by that province's securities commission;

3. The market capitalization of issuers in an industry headquartered in a province as a percentage of the total market capitalization of all issuers in that industry; and

4. The market capitalization of issuers in an industry headquartered in a province as a percentage of the market capitalization all issuers principally regulated by that province's securities commission.

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5 *Ibid* at 51-52.

6 See National Policy 43-201 *Mutual Reliance Review System for Prospectuses and AIFs* and National Policy 12-201 *Mutual Reliance Review System for Exemptive Relief Applications.* The MRRS is intended to reduce unnecessary duplication in the review of materials filed in multiple jurisdictions. While an issuer is nonetheless required to file documents with all of the securities regulators in the jurisdictions in which securities are being distributed, the issuer is allowed to choose a principal regulator that has primary responsibility for reviewing the materials and providing comments. As at January 25, 2002, the securities regulators of British Columbia, Alberta, Saskatchewan, Manitoba, Ontario, Quebec and Nova Scotia had agreed to act as principal regulators under National Policy 43-201. Under the MRRS, an issuer's principal regulator is: (a) the local securities regulatory authority in the jurisdiction in which the issuer's head office is located; or (b) if the issuer's head office is not in a jurisdiction in which a participating principal regulator is located, then an issuer can select a participating principal regulator as its principal regulator, if the issuer has a reasonable connection with the relevant jurisdiction. Both an issuer and a principal regulator can propose to change the principal regulator.

7 Previously defined as "LICR."

This study assumes that regulatory responsiveness and expertise are proportional to the absolute importance of an issuer segment as well as its market capitalization. It may be, however, that commissions devote slightly more resources to industries that dominate in their respective provinces. For example, if the largest issuer group in any particular province represents one-third of all issuers in that jurisdiction, it may demand and receive more than one third of the regulator's attention. The smallest groups of issuers may receive less than their directly proportionate share of attention.

The issue of the minimum required critical mass of issuers in any particular industry for a regulator to establish expertise in the area also bears on how regulatory expertise is distributed among the provincial and territorial regulators.

It is inferred that local regulatory expertise will develop in provinces that host LICRs because of the volume of transactions that local regulators will review from issuers in the relevant industry and their interaction with such issuers and their service providers. However, the location of an industry's LICR does not provide any indication of the location of its investors. The province in which an issuer's head office is located, which is the basis this study uses for determining whether an LICR exists, does not indicate where the majority of its investors reside. The debate on local and regional interests appears to have focused, thus far, on issuers. However, an analysis of whether distinct local markets exist in Canada must also consider investor location and whether there are appreciable differences among investors throughout the country that would create a need for distinct local regulation.

In addition, the province in which an issuer's head office is located does not necessarily indicate where the majority of its operations takes place. Hence, the LICR for any given industry does not necessarily correlate with the industry's contribution to the provincial economy, as evidenced by GDP data broken down by province and industry. For example, the relative economic impact of the mining industry in the Northwest Territories' GDP is over nine times greater than in B.C.'s GDP.[8] Certain mining issuers that are headquartered in B.C. and therefore subject to the British Columbia Securities Commission (BCSC) as principal regulator are actually engaged in mining exploration in Newfoundland and the Northwest Territories. Even though the bulk of such issuers' economic activities is taking place in other parts of the country, they may have decided to locate their head offices in B.C. because of the province's LICR for mining. Therefore, the level of mining in B.C. or the significance of the mining industry to the B.C. economy cannot be determined simply based on the number, or percentage, of public companies headquartered there.[9] As such, it is also difficult to argue that B.C. has more of an interest in the LICR for mining than other jurisdictions where mining activities are actually undertaken.

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8 See Appendix A, Tables 1b and c.

9 Further to this point, Ontario Teachers Pension Plan has stated that "We are uncertain as to whether there are distinctive regional or local characteristics in Canadian capital markets that are not simply the result of particular concentrations of different industry segments in different parts of the country." Ontario Teachers Pension Plan Board, submission to WPC. Furthermore, Osler, Hoskin & Harcourt submitted to the Wise Persons' Committee that "although there are regions of the country where issuers in a particular industry may be concentrated, in our experience the capital markets activities of Canadian issuers generally extend beyond provincial boundaries". Osler, Hoskin & Harcourt, submission to WPC.

(a) *TSX and TSX Venture Exchange Data*

There are a total of 3,263 issuers listed on the TSX and TSX Venture Exchange.[10]

Of the 1,222 issuers listed on the TSX, the greatest portion consists of issuers headquartered in Ontario (577 issuers at 47%).[11] This is followed by Alberta (233 issuers at 19%), and B.C. and Quebec (each with 177 issuers at 14% each). The remaining provinces and territories each headquarter less than 2% each of TSX listed issuers.

The total market capitalization of all issuers listed on the TSX is approximately $923.0 billion. Over one-half of the market capitalization is comprised of issuers headquartered in Ontario ($492.6 billion at 53%).[12] This is followed by Alberta ($177.8 billion at 19%), Quebec ($155.6 billion at 17%), B.C. ($45.2 billion at 5%), and Manitoba ($30.2 billion at 3%).[13]

Most TSX listed issuers fall into one of four industry classifications: Diversified Industries (339 issuers at 28%), Financial Services (243 issuers at 20%), Mining (159 issuers at 13%), and Oil and Gas (123 issuers at 10%).[14]

The Financial Services and Oil and Gas industries each represent a greater proportionate share of total market capitalization than absolute issuer base. Financial Services issuers represent 32% and Oil and Gas 23% of the total market capitalization of the TSX, while Mining represents 9%.[15]

Of the 2,041 issuers listed on the TSX Venture Exchange, the greatest portion consists of issuers headquartered in B.C. (983 issuers at 48%).[16] This is followed by Alberta (415 issuers at 22%), Ontario (415 issuers at 20%), and Quebec (142 issuers at 7%).

The total market capitalization of all issuers listed on the TSX Venture Exchange is approximately $11.8 billion. Over 40% of the TSX Venture Exchange's market capitalization is comprised of issuers headquartered in B.C.[17] This is followed by Alberta (at 27%), Ontario (at 21%), and Quebec (at 7%).[18]

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10 See Appendix B, Table 1a and Table 1b. TSX data is current as at May 31, 2003. TSX Venture Exchange data is current as at July 7, 2003.

11 Appendix B, Table 1a.

12 Appendix B, Table 1c.

13 *Ibid.*

14 Appendix B, Table 1a.

15 Appendix B, Table 1c.

16 Appendix B, Table 1b.

17 Appendix B, Table 1d.

18 *Ibid.*

Almost one half of all TSX Venture exchange issuers are classified as Mining issuers (918 issuers at 45%) followed by Technology issuers (324 at 16%), Diversified Industry issuers (335 at 16%) and Oil and Gas issuers (282 at 14%).[19]

The market capitalization analysis reveals similar results. Mining represents 45% of the total market capitalization of the TSX Venture Exchange, followed by Oil and Gas at 20%, Diversified Industries at 16%, and Technology at 13%.[20]

(i) Oil and Gas

<u>TSX Data:</u>

Oil and Gas issuers represent 10% of all TSX listed issuers.[21] Of the 123 Oil and Gas issuers listed on the TSX, 113 (92%) are headquartered in Alberta and therefore most likely regulated by the Alberta Securities Commission (ASC) as the principal regulator under MRRS.[22] While Alberta headquarters an overwhelming majority of Oil and Gas issuers in absolute terms, it hosts only slightly more than one-half of the total market capitalization of all Oil and Gas issuers (55%).[23] Ontario follows at 8% and the remaining Canadian jurisdictions each host less than 1% of the market capitalization of this industry.[24] Surprisingly, foreign issuers comprise 36% of the industry's market capitalization. In fact, BP p.l.c, the largest of such issuers, represents 27% of the market capitalization of all oil and gas listed on the TSX, followed by Burlington Resources Inc., at 7%.[25]

The ASC likely acts as principal regulator for 233 TSX listed issuers under MRRS, and as such, Oil and Gas issuers represent 48% (113/233) of the ASC's issuers listed on the TSX that are headquartered in Alberta.[26] However, Oil and Gas issuers listed on the TSX comprise 67% of the total market capitalization of all TSX issuers headquartered in Alberta.[27]

<u>TSX Venture Exchange Data:</u>

Oil and Gas issuers represent 14% of all TSX Venture Exchange listed issuers.[28] Of the 282 Oil and Gas issuers listed on the TSX Venture Exchange, a substantial majority (173 issuers at 61%) are headquartered in Alberta.[29] Oil and Gas issuers headquartered in Alberta comprise

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19 Appendix B, Table 1b.
20 Appendix B, Table 1d.
21 Appendix B, Table 1a.
22 See National Policies 43-201 and 12-201, *supra* note 6.
23 Appendix B, Table 1c.
24 *Ibid.*
25 The total market capitalization of all foreign oil and gas issuers listed on the TSX is $77.0 billion. BP p.l.c, (headquartered in the U.K.) has a market capitalization of $58.4 billion. This is followed by Burlington Resources Inc. (headquartered in the U.S.) with a market capitalization of $14.5 billion, Murphy Oil Corporation (headquartered in the U.S.) with a market capitalization of $2.1 billion, and Ultra Petroleum Corp. (headquartered in the U.S.) with a market capitalization of $1.2 billion (as at May 31, 2003).
26 Appendix B, Table 1a.
27 *Ibid.*
28 Appendix B, Table 1b.
29 Appendix B, Table 1d.

77% of the market capitalization of all oil and gas issuers listed on the TSX Venture Exchange ($1.9 billion out of total industry market capitalization of $2.4 billion).[30]

The ASC acts as principal regulator for 440 TSX Venture Exchange listed issuers under MRRS, and as such, Oil and Gas issuers represent 39% (173/440) of the ASC's issuers listed on the TSX Venture Exchange that are headquartered in Alberta.[31] However, Oil and Gas issuers represent 58% of the total market capitalization of all TSX Venture Exchange issuers principally regulated by the ASC.[32]

Analysis:

These figures provide strong support for the claim that there is an LICR for Oil and Gas issuers in Alberta.

(ii) Mining

TSX Data:

Mining issuers represent 13% of all TSX listed issuers. Ontario and B.C. are headquarters to over 80% of the 159 Mining issuers listed on the TSX.[33] Slightly more are headquartered in Ontario (68 issuers at 43%) than in B.C. (60 issuers at 40%).

In respect of market capitalization, Mining issuers headquartered in Ontario comprise 49% of the total market capitalization of all Mining issuers listed on the TSX, while those headquartered in B.C. comprise 16% of the industry's total market capitalization.[34]

These data are surprising given that a blanket generalization is often made that the majority of Mining issuers are located in B.C. The data does not bear this claim out in respect of TSX listed issuers, although there is more merit to the claim upon examination of TSX Venture Exchange data, set out below.

However, Mining issuers represent a greater proportionate share of the BCSC's total TSX listed issuer base as compared to the Ontario Securities Commission (OSC). Mining issuers represent 9% of the total market capitalization of all TSX issuers principally regulated by the OSC but 31% of those regulated by the BCSC.[35]

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30 Appendix B, Table 1d.
31 Appendix B, Table 1b.
32 Appendix B, Table 1d.
33 Appendix B, Table 1a.
34 Appendix B, Table 1c.
35 *Ibid.*

TSX Venture Exchange Data:

Mining issuers represent almost one-half of all TSX Venture Exchange listed issuers (45%). A large majority of the 918 Mining issuers are headquartered in B.C. (584 issuers at 64%).[36] Ontario (168 issuers at 18%) and Alberta (77 issuers at 8%) follow.

The market capitalization analysis roughly parallels the above analysis. Mining issuers headquartered in B.C. comprise 60% of the market capitalization of all Mining issuers listed on the TSX Venture Exchange ($3.2 billion out of total industry market capitalization of $5.2 billion).[37] This is followed by Ontario at 21%, Alberta at 8% and Quebec at 7%.[38]

Mining issuers headquartered in B.C. comprise 65% of the total market capitalization of all TSX Venture Exchange issuers principally regulated by the BCSC.[39] This is followed by Saskatchewan at 61%, Ontario at 43%, Quebec at 42%, Nova Scotia at 17%, and Alberta at 13%.[40]

Analysis:

The data suggest that both B.C. and Ontario host an LICR for TSX listed mining issuers. The data also support the claim that B.C. hosts an LICR for TSX Venture Exchange listed mining issuers.

(iii) Technology

TSX Data:

Technology issuers represent 10% of all TSX listed issuers. Of the 128 Technology issuers on the TSX, the majority are headquartered in Ontario (74 issuers at 58%).[41] This is followed by B.C. (24 issuers at 19%), Quebec (19 issuers at 15%), and Alberta (10 issuers at 8%).[42] The market capitalization data are slightly more pronounced than the absolute numbers in favour of Ontario. Technology issuers headquartered in Ontario comprise 83% of the market capitalization of all technology issuers listed on the TSX.[43] This is followed by Quebec at 9% and B.C. at 7%.[44]

Technology issuers represent a relatively low proportion of each provincial regulator's overall TSX listed issuer base with each of B.C., Ontario, Quebec and Alberta at 14% or under.[45]

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36 Appendix B, Table 1b.
37 Appendix B, Table 1d.
38 *Ibid.*
39 *Ibid.*
40 *Ibid.*
41 Appendix B, Table 1a.
42 *Ibid.*
43 Appendix B, Table 1c.
44 *Ibid.*
45 Appendix B, Table 1a.

Technology issuers represent 8% of the total market capitalization of all TSX issuers principally regulated by the OSC. This is followed by B.C. at 7% and Quebec at 3%.[46]

TSX Venture Exchange Data:

Technology issuers represent 16% (324/2041) of all TSX Venture Exchange listed issuers. Of the 324 Technology issuers on the TSX Venture Exchange, a significant number are headquartered in B.C. (139 issuers at 43%).[47] This is followed by Ontario (78 at 24%), Alberta (62 issuers at 19%) and Quebec (34 issuers at 10%).[48]

B.C.'s lead is slightly less pronounced when market capitalization data are analysed. Technology issuers headquartered in B.C. comprise 32% of the market capitalization of all technology issuers listed on the TSX Venture Exchange, followed closely by Ontario at 30%, Alberta at 16% and Quebec at 10%.[49]

From the perspective of the provinces, technology issuers represent between 14% to 25% of each of Alberta, B.C., Manitoba, N.B., N.S., Ontario, Quebec, and Saskatchewan's TSX Venture Exchange issuer base.[50] However, Technology issuers represent more of the total market capitalization of all TSX Venture Exchange issuers principally regulated by Ontario and Quebec (19% and 18% respectively) than B.C. and Alberta (10% and 8% respectively).[51]

Analysis:

While a generalization is often made that B.C. is a hotbed for technology issuers, the data reveal that Ontario actually hosts an LICR for TSX listed technology companies while B.C. hosts an LICR for TSX Venture Exchange listed technology issuers.

It is interesting to note that there are many similarities between technology companies and mining companies, which provides a partial explanation as to why an LICR for TSX Venture Exchange listed technology issuers is developing in B.C. Both mining and technology companies often have no or limited revenue streams in the early part of their business cycle, making investments in such companies rather speculative. Relatedly, the LICR for technology companies in B.C. is at a much more nascent stage than the LICR for mining companies because the technology industry is at a much earlier stage in its development than mining.

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46 Appendix B, Table 1c.
47 Appendix B, Table 1b.
48 *Ibid.*
49 Appendix B, Table 1d.
50 Appendix B, Table 1b.
51 Appendix B, Table 1d.

(iv) Financial Services

TSX Data:

Financial Services issuers represent 20% of the TSX listed issuers.[52] Of the 243 Financial Services issuers listed on the TSX, almost 80% (193 issuers at 79%) are headquartered in Ontario. The market capitalization data produces similar results. Financial Services issuers headquartered in Ontario comprise 76% of the market capitalization of all financial services issuers listed on the TSX.[53]

TSX listed Financial Services issuers represent 33% of the OSC's TSX listed headquartered issuers,[54] but 45% of the total market capitalization of all TSX issuers headquartered there.[55]

TSX Venture Exchange Data:

Financial Services issuers represent a very small component of the TSX Venture Exchange at 4% (81 issuers).[56] Of those 81 issuers, a significant portion is headquartered in Ontario (32 issuers at 40%). This is followed by B.C. (31 issuers at 25%) and Alberta (17 issuers at 21%). Financial Services issuers clearly do not cluster on the TSX Venture Exchange.

The market capitalization data maintains the above rankings, but Ontario's lead is more pronounced and B.C. and Alberta share of market capitalization is slightly less than their absolute numbers suggest. Financial Services issuers headquartered in Ontario comprise 61% of the market capitalization of all financial services issuers listed on the TSX Venture Exchange.[57] This is followed by B.C. at 15% and Alberta at 13%.

Financial Services issuers listed on the TSX Venture Exchange represent less than 5% of each provincial regulator's headquartered issuer base.[58] Financial Services issuers comprise 11% of the total market capitalization of all TSX Venture Exchange issuers principally regulated by the OSC.[59]

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52 Appendix B, Table 1a.
53 Appendix B, Table 1c.
54 Appendix B, Table 1a.
55 Appendix B, Table 1c.
56 Appendix B, Table 1b.
57 Appendix B, Table 1d.
58 Appendix B, Table 1b.
59 Appendix B, Table 1d.

Analysis:

The data indicate that Ontario hosts an LICR for financial services issuers.

(v) Communications & Media

TSX Data:

Communications and Media issuers represent only 5% of all TSX listed issuers. Ontario and Quebec are headquarters to 73% of all Communications and Media issuers listed on the TSX.[60] More are headquartered in Ontario (31 issuers at 46%) than in Quebec (18 issuers at 27%).

In respect of market capitalization, however, both Ontario and Quebec each headquarter 39% of the total market capitalization of this industry.

However, Communications and Media issuers appear to consume a greater proportionate share of the Quebec Securities Commission's (QSC) resources as compared to the OSC. Communications and Media issuers represent 10% of all TSX listed issuers principally regulated by the QSC, as opposed to 5% of the OSC's principally regulated TSX listed issuer base. In respect of market capitalization, Communications and Media issuers represent 8% of the total market capitalization of all TSX issuers principally regulated by the OSC but one quarter of those regulated by the QSC.[61]

TSX Venture Exchange Data:

Communications and Media issuers represent only 1% of all TSX Venture Exchange listed issuers. Of the 29 Communications and Media issuers, almost one half are headquartered in B.C. (14 issuers at 48%), followed by Ontario at 31%, Alberta at 17% and Quebec at 4%.[62]

The market capitalization data suggest quite different results: Alberta's issuer base for this industry represents 71% of the industry's total market capitalization.[63] This is followed by B.C. at 15%, Ontario at 13% and Quebec at 2%.[64]

Communications and Media issuers headquartered in each of the provinces and territories comprise less than 2% of the issuers principally regulated by that province and less than 6% of the total market capitalization of all TSX Venture Exchange issuers principally regulated by that jurisdiction's securities regulator.[65]

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60 Appendix B, Table 1a.
61 *Ibid.*
62 Appendix B, Table 1b.
63 Appendix B, Table 1d.
64 *Ibid.*
65 *Ibid.*

Analysis:

Ontario and Quebec each have an LICR in Communications and Media issuers listed on the TSX. This industry appears to consume more proportionate resources of the QSC than the OSC. B.C., Ontario and Alberta appear to have an LICR in Communications and Media issuers listed on the TSX Venture Exchange: B.C. and Ontario because of the absolute number of issuers in the industry headquartered in there and Alberta because of the strength of the market capitalization of the industry's issuers that are located in that province.

(vi) Diversified Industries

TSX Data:

Diversified Industry issuers represent 28% of all TSX listed issuers. Of the 339 Diversified Industry issuers on the TSX, the majority are headquartered in Ontario (155 issuers at 46%).[66] This is followed by Quebec (65 issuers at 19%), Alberta (57 issuers at 17%), and B.C. (40 issuers at 12%).[67]

The market capitalization data shows that Ontario still ranks first (at 43%) but with a smaller lead than the absolute numbers above suggest.[68] Diversified Industry issuers headquartered in Quebec comprise 29% of the total market capitalization of all Diversified Industry issuers listed on the TSX, which represents a larger share than the absolute numbers indicate above.[69] This is followed by Alberta and B.C. each at 15%. [70]

Diversified Industry issuers represent 37% of the QSC's TSX listed issuer base and 27% of the OSC's TSX listed issuer base. This is followed by the ASC at 24% and the BCSC at 23%.[71]

The above rankings remain the same when market capitalization data are considered, although the industry represents a smaller proportion of each regulator's overall TSX listed issuer base: Diversified Industry issuers represent 29% of the TSX listed issuer base headquartered in Quebec. This is followed by Ontario at 20%, and Alberta and B.C., each at 15%.[72]

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66 Appendix B, Table 1a.
67 *Ibid.*
68 Appendix B, Table 1c.
69 *Ibid.*
70 *Ibid.*
71 Appendix B, Table 1a.
72 Appendix B, Table 1c.

TSX Venture Exchange Data:

Diversified Industries issuers represent 16% (335/2041) of all TSX Venture Exchange listed issuers. Two thirds of the 335 Diversified Industry issuers on the TSX Venture Exchange are headquartered in Ontario and B.C., (33% each at 111 issuers each).[73] This is followed by Alberta (81 at 24%), and Quebec (31 issuers at 9%).[74] In respect of market capitalization, B.C. ranks first, as headquarters to 36% of Diversified Industry issuers listed on the TSX Venture Exchange. This is followed by Ontario at 25%, Alberta at 18% and Quebec at 13%.[75]

From the perspective of the provinces, however, Diversified Industry issuers represent the greatest portion of the OSC's TSX Venture Exchange issuer base: the industry represents 24% of the QSC's TSX Venture Exchange issuer base, followed by the QSC at 24%, 18% of the ASC's TSX Venture Exchange issuer base and 11% of the BCSC's TSX Venture Exchange issuer.[76]

However, the market capitalization data suggest that Diversified Industry issuers represent the greatest portion of Quebec's TSX headquartered issuer base at 29%, which is greater than Ontario, Alberta and B.C., all of which are under 20%.[77]

(vii) Life Sciences

TSX Data:

Life Sciences issuers represent only 6% of all TSX listed issuers. Ontario and Quebec are headquarters to over 70% of all Life Sciences issuers listed on the TSX.[78] Slightly more are headquartered in Ontario (27 issuers at 37%) than in Quebec (25 issuers at 34%). This is followed by B.C. (14 issuers at 19%) and Alberta (5 issuers at 7%).[79]

However, Ontario is headquarters to two-thirds of the total market capitalization of this industry, while Quebec is headquarters to only 12% of the total market capitalization of the industry.[80]

From the perspective of the provinces, however, Life Sciences represent the greatest portion of the QSC's TSX headquartered issuer base at 14%. Life Sciences represent less than 10% of all other jurisdictions' TSX headquartered issuer base.[81]

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73 Appendix B, Table 1b.
74 *Ibid.*
75 Appendix B, Table 1d.
76 Appendix B, Table 1b.
77 Appendix B, Table 1d.
78 Appendix B, Table 1a.
79 Appendix B, Table 1a.
80 Appendix B, Table 1c.
81 Appendix B, Table 1a.

TSX Venture Exchange Data:

There are no Life Sciences issuers listed on the TSX Venture Exchange.[82]

Analysis:

The data suggest that Ontario and Quebec each host an LICR for TSX listed Life Sciences issuers.

(viii) Micro and Small Cap Issuers

For the purpose of this analysis, a micro cap issuer is defined as having a market capitalization of less than $5 million and a small cap issuer is defined as having a market capitalization of $5 to $75 million.[83]

TSX Data:

Micro cap issuers represent 7% of all TSX listed issuers.[84] Of the 85 micro cap issuers listed on the TSX, more than half (46 issuers at 55%) are headquartered in Ontario. This is followed by B.C. at (22 issuers at 26%), and then Quebec and Alberta (each at 7 issuers at 8% each.)

Micro-cap issuers listed on the TSX represent between 12% to 3% of B.C., Ontario, Quebec and Alberta's issuers headquartered in each province.

Small cap issuers represent 43% of all TSX listed issuers. Of the 520 small cap issuers listed on the TSX, just under half (227 issuers at 45%) are headquartered in Ontario and therefore most likely regulated by the OSC as the principal regulator under MRRS. This is followed by B.C. and Alberta (95 issuers each at 18% each) and Quebec (84 issuers at 16%.)

Small cap issuers represent a relatively high proportion of each regulator's headquartered issuers listed on the TSX: 54% for B.C., 47% for Quebec, and 41% for each of Alberta and Ontario.

TSX Venture Exchange Data:

Micro cap issuers represent 76% of all TSX Venture Exchange listed issuers.[85] Of the 1,705 micro cap issuers listed on the TSX Venture Exchange, over one half (882 issuers at 52%) are headquartered in B.C. and therefore most likely regulated by the BCSC as the principal regulator under MRRS. This is followed by Alberta (335 issuers at 20%), Ontario (329 issuers at 19%) and Quebec (112 issuers at 7%).

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82 Appendix B, Table 1b.

83 See submission from the Ontario Securities Commission to Wise Persons' Committee which also used the same classification. Ontario Securities Commission, submission to WPC.

84 See Appendix B, Tables 2a and 2b.

85 See Appendix B, Tables 3a and 3b.

Micro cap issuers represent an extraordinary percentage of each regulator's headquartered issuers listed on the TSX Venture Exchange. B.C. ranks first (886/983 issuers at 81%). This is followed by Quebec and Ontario (112/142 issuers and 329/415 issuers, respectively, at 79% each) and then Alberta (335/440 issuers at 76%.)

Small cap issuers represent 23% of all TSX Venture Exchange listed issuers. Of the 519 small cap issuers listed on the TSX Venture Exchange, 204 (39%) are headquartered in B.C. and therefore most likely regulated by the BCSC as the principal regulator under MRRS. This is followed by Alberta (139 issuers at 27%), Ontario (108 issuers at 21%) and Quebec (43 issuers at 8%.)

Small cap issuers represent 32% of Alberta's headquartered TSX Venture Exchange issuer base, followed by Quebec at 30%, Ontario at 26% and B.C. at 19%.

Combined TSX and TSX Venture Exchange Data:

Micro cap issuers represent 52% of all issuers listed on either the TSX or the TSX Venture Exchange.[86] Of the 1,789 micro cap issuers listed on one of the two exchanges, a majority (908 issuers at 51%) are headquartered in B.C. and therefore most likely regulated by the BCSC as the principal regulator under MRRS. This is followed by Ontario (375 issuers at 21%), Alberta (342 issuers at 19%) and Quebec (119 issuers at 7%).

The BCSC acts as principal regulator for 1,271 issuers on both exchanges under MRRS and as such, micro cap issuers represent 71% (908) of the BCSC's issuers listed on either exchange. This is followed by Alberta (51%), Ontario (38%) and Quebec (37%).

Small cap issuers represent 30% of all issuers listed on either the TSX or the TSX Venture Exchange. Of the 1,036 small cap issuers listed on both exchanges, just under one third (335 issuers at 32%) are headquartered in Ontario and therefore most likely regulated by the OSC as the principal regulator under MRRS. Ontario is followed closely by B.C. (29%) and Alberta (23%). Quebec ranks fourth (12%).

Small cap issuers represent between 24 and 40% of each regulator's headquartered issuers with Quebec at 40%, Alberta at 35%, Ontario at 33% and B.C. at 24%.

Analysis:

The TSX data suggest that Ontario hosts an LICR for both micro and small cap issuers. However, the TSX Venture Exchange data suggests that B.C. hosts the LICR for both micro cap and small cap issuers on this exchange. The aggregate data from both exchanges highlight that B.C. hosts an LICR for micro cap issuers and Ontario, B.C. and Alberta each host LICRs for small cap issuers.

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[86] See Appendix B, Tables 4a and 4b.

(b) *Investor Location*

The debate on local and regional markets appears to have focused on issuers. However, an analysis of whether distinct geographic markets exist in Canada must also consider investor location and whether there are appreciable differences among investors throughout the country that would create a need for distinct local regulation.

As the OSC states in its submission to the Wise Persons' Committee:

> There are, of course, regional economic concerns within Canada, but no longer is anything just a regional concern; no economic sector or issue is the exclusive concern of any province, territory or region. The oil industry is as much potential interest to investors in Ontario or Quebec as it is in Alberta. The auto parts industry is of as much potential interest to investors in Alberta as it is to investors in Ontario; the biotech industry is as important to investors in Prince Edward Island as to investors in Quebec.[87]

The location of an industry's LICR does not provide any indication of the location of its investors. The province in which an issuer's head office is located, which is the basis for determining LICR, does not indicate where the majority of its investors reside.

While Professors Cumming, Kaul and Mehrotra find that most private equity investors reside in the same province as the entrepreneurs in whose companies they invest,[88] their findings cannot be generalized for all stages of financing and investors because of the distinct nature of the venture capital and private equity market. In addition, data on investor location for public companies is generally unavailable.[89]

If it is true that investors are located throughout the county for other types of financings, then in considering the issue of distinct local and regional interests from the perspective of investors, one would need to consider whether investors that reside in particular provinces have distinct characteristics that would justify the need for different levels or forms of regulation.

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87 *Supra* note 83. Similarly, the Prospectors and Developers Association of Canada stated the following in relation the mining industry in its submission to the Wise Persons' Committee: "We believe that the exploration industry is a national industry for several reasons. First, the issuers are resident in primarily B.C. and Ontario but they also exist in Quebec, Alberta, Saskatchewan and the Maritimes. Second, investors are resident in primarily B.C. and Ontario but they also exist in Quebec, Alberta, Saskatchewan and the Maritimes. This means that issuers, regardless of their home jurisdiction, must raise financing in multiple jurisdictions – particularly as their projects advance. We don't accept the notion that certain provincial regulators should be charged with advancing the interests of certain industries or certain sized issuers because this implies that the other regulators are letting down companies or investors who reside in their jurisdictions. As well, we don't see why these so-called regional issues could not be handled by the local offices of a single regulator or by the office of a single regulator which is charged with administering the affairs of an industry or other issuer group." PDAC, submission to WPC.

88 D. Cumming, A. Kaul and V. Mehrotra, "Provincial Preferences in Private Equity" (WPC Research Study, 2003).

89 See D. Cumming, A. Kaul and V. Mehrotra, "Fragmentation and the Canadian Stock Markets" (WPC Research Study, 2003).

It should be noted that issuers are more likely than investors to apply pressure on local regulators to develop locally and regionally-specific rules and policies. Issuers and their professional advisors have frequent and sustained contact with securities regulators and many opportunities to have their views heard. This statement cannot be made with the same force about investors. Despite having a mandate of "investor protection", securities regulators have infrequent contact with retail investors. Retail investors in widely held public companies do not have the economic incentives to apply pressure on regulators to adopt locally-specific rules or policies. While institutional investors have better incentives to make their views known to regulators, they are unlikely, as a general matter, to focus on rule changes that deal with local or regional issues. Instead, institutional investors are more likely to apply pressure on regulators to develop rules and policies that can be applied across the board to the entire spectrum of issuers in which they invest, such as corporate governance initiatives. There may, however, be some instances where investors' interests are closely aligned with issuers' interests, as in the context of a private company about to go public, and where both sets of stakeholders have an interest in pressuring regulators.[90]

(c) *GDP Analysis*

The stock exchange data above allow us to conclude that Alberta hosts an LICR in oil and gas, B.C. an LICR in mining and technology, Ontario an LICR in mining, technology, financial services, communications and media, and life sciences, and Quebec an LICR in communications and media and life sciences. As well, the data allow us to conclude that Alberta, B.C. and Ontario each host an LICR for small cap issuers, and B.C. an LICR for micro-cap issuers.

To be sure, however, the above data do not allow us to conclude that these industries are local to host provinces or that host provinces have distinct local interests in the capital markets regulation or general regulation of those industries.

This section examines data on GDP,[91] classified by province and industry, to examine the economic significance of selected industries to the provinces that host their LICRs and other provinces.

Statistics Canada provides only aggregate figures for "Mining and Oil and Gas Extraction." Mining and Oil and Gas Extraction represents 17.1% ($20.5 billion) of Alberta's GDP but only 3% of B.C.'s GDP ($3.2 billion).[92] This industry is of greater proportionate significance to the economies of the Northwest Territories[93] (representing 28% of its GDP at

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90 As discussed in the following section, provincial securities regulators have been responsive to the needs of both issuers and early stage investors.

91 Industry GDP estimates are prepared using a value added approach, which is the value of an industry's gross output less the value of intermediate inputs required in the production process. GDP is *gross* in the sense that it does not deduct items such as the depreciation of capital assets.

92 See Appendix A, Tables 1a and b.

93 See Appendix A, Table 1c.

$766 million), Newfoundland[94] (representing 17.9% of its GDP at $2.3 billion) and Saskatchewan[95] (representing 14% of its GDP at $4 billion).

GDP data by province and industry reveal that "Finance, Insurance and Real Estate" represents 22% of Ontario's GDP ($88.7 billion) but also represents 12% to 23% of all the other provinces and territories' GDP.[96] As such, it would not be valid to claim that financial services is an industry local to Ontario: financial services is important to the economies of all the provinces and no one province has inherent ownership in fostering the general growth of this industry or encouraging capital formation for this industry.

Even though the infrastructure for capital raising for these industries may be clustered in certain regions of the country, the above GDP data suggest that the economic significance of these industries transcends regional boundaries, and that many provinces are interested in fostering policies and programs that encourage such industries. As a result, it is not improper to conclude that these industries are national in character.

(d) *Implications for Optimal Regulatory Structure*

The above analysis reveals that infrastructures for capital raising for certain industries are centred in certain regions in Canada. Other provinces may have an interest equal to that of the province that hosts the LICR, however, given investor location and the importance of those industries to the economies of other provinces, as borne out by GDP data.

While securities regulatory responsibility is currently divided on the basis of issuer location, it is not the only plausible allocation; investor location and economic impact are two other bases that could potentially be used.

In assessing possible alternatives to the current regulatory structure, the local regulatory expertise that has developed as a result of LICRs for certain industries should be preserved.

Under a USL Model, existing provincial commissions would continue to operate in a manner similar to that under the current system, and thus would allow existing local regulatory expertise to be maintained.

A Passport Model based on issuer location or issuer choice will also likely preserve existing regulatory expertise because issuers will likely choose to headquarter or choose to be regulated by the regulator that is considered to be the expert for that particular industry.

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94 See Appendix A, Table 1d.
95 See Appendix A, Table 1e.
96 See Appendix A, Tables 1a to 1g.

A single regulator model, properly designed, can also preserve existing local regulatory expertise.[97] This model will also allow for a consolidation of expertise to the extent that it is dispersed among many regulators under the current system. A single regulator ought to also be divided along major industry lines that currently have LICRs, and should also have a unit focused on smaller issuers.

A single regulator model must also address the issue of whether the existing regulatory expertise should be housed in regional offices. With advances in communication technology, regulatory experts need not necessarily be housed in the existing LICR. However, it may be desirable to do so. The impact of this desire depends on the weight to be accorded to it, relative to factors favouring centralized staffing and expertise. Stakeholders have expressed the view that "face to face" contact with regulators (or the possibility of the same) is important to issuers and their professional advisors. This close contact may in part account for the development of LICRs and help to explain the development of the regulatory expertise in these industries. A single regulator model must also address the issue of the power and scope of authority that may be vested in regional offices.

A concern that is often expressed is that a single regulator model will pay more attention to larger issuers and not be as responsive to smaller issuers; a concerted effort must be made to avoid this result.[98] As discussed in Part 5 below, the SEC has a small business unit within its Division of Corporation Finance, which suggests one approach to addressing this concern.

It should be highlighted here that the needs of smaller issuers should not be conflated with the need for local rules. Smaller issuers that engage in (or expect to engage in) inter-provincial capital activity need rules that will allow for the raising of capital in a cost effective manner.[99] As will be discussed in Part 4, even exclusively intra-provincial issuers may not need

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97 CIBC's submission to the Wise Persons' Committee states "The governance structure [of a national regulator] must represent the regional needs of the country using the high level of skills and securities experience currently found in the provincial commissions… The high levels of regulatory, legal, accounting and other skills currently available in many provinces should continue to be used in the creation of the national regulator for example by using certain offices as the centres for certain kinds of specializations." CIBC, submission to WPC. See also, Phillips, Hager & North, which has stated in this regard: "we do not see why a central regulator cannot develop or hire the expertise to address regional and local needs. Be it oil and gas, mining, fishery, expertise can be bought with savings from having a centralized regulator rather than 13 jurisdictions." Phillips, Hager & North, submission to WPC.

98 According to Discovery Capital Corporation, a B.C. venture capital firm, "The Inter-Provincial Securities Framework must preserve the opportunity to innovate regionally that has resulted in significant improvements to the regulatory regime for junior issuers in Canada." Discovery Capital Corporation, submission to WPC.

99 See also Ogilvy Renault's submission to the Wise Persons' Committee, in which it states, "local laws are perceived to facilitate access to the securities market by, and appropriate regulation of, smaller regional or sectoral issuers. We are of the view that these laws can also be enacted and enforced on a uniform basis. There are smaller market participants in all jurisdictions of Canada who need to access low-cost, innovative financing. Smaller issuers are not well served by having separate non-uniform compliance regimes in thirteen provinces and territories: in fact, their ability to raise capital in more than one jurisdiction is impaired by cost and complexity." Ogilvy Renault, submission to WPC.

purely local rules, depending on the underlying rationale for the rule.[100]

3. Local Regulatory Responsiveness

This part analyzes whether local securities regulators have developed regulatory products that are responsive to their distinct local and regional capital markets.

This part examines only external indicia of regulatory activity such as legislation, rules, and policies and does not examine internal regulatory activity such as different approaches to the administration of legislation, rules and policies that may exist between provincial regulators.

In particular, this part reviews the regulatory products that have emerged from the provincial securities commissions, and that have been argued to be the products of regulatory responses to local and regional market needs, including: (a) the Junior Capital Pool Programs; (b) the System for Shorter Hold Periods with an Annual Information Form and Multilateral Instrument 45-102 *Resale of Securities*; (c) National Instrument 51-101 *Standards of Disclosure for Oil & Gas Activities*; (d) the OSC's Accredited Investor Exemption and Multilateral Instrument 45-103 *Capital Raising Exemptions*; and (e) Saskatchewan's Local Policy 45-601 *Community Venture Exemption*.

The following list of non-exhaustive factors is instructive in analyzing the issue of whether local regulators have been responsive to distinct local markets or issues:

- Was the creation of the local policy followed by multilateral or national adoption by other provincial regulators? If so, then the local policy may be an example of regulatory innovation possibly supporting an argument for regulatory experimentation but not an argument for local regulation of distinct local markets. In assessing this factor, there may be a difference of degree rather than kind; that is, the need for a policy, while not unique to any one local jurisdiction, may be more pronounced there, and so may have lead to the innovation.

- Was the local policy created for the purpose of supporting an industry that is local to the province? If other provinces do not host the relevant industry in their geographical boundaries and are not interested in its development, then the local policy likely responds to a distinct local market.

- Is the local policy's application limited to issuers and investors that are all within the province? If investors are not located within the same province as the issuers to whom the policy applies, the local policy is not likely responding to a distinct local market.

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[100] Given that one potential model of regulatory reform would leave the provinces regulating purely intra-provincial offerings, it is important to understand the economic significance of such offerings. The focus is on offerings - whether exempt or by prospectus – that are extended only to residents of the province in which the issuer is located. Even offerings that were available to a single resident of one additional province would not count, as they would be considered inter-provincial. This study was not able to obtain aggregate data to analyze the extent of such intra-provincial offerings in Canada.

However, the fact that issuers and investors may be located in the same province is not determinative of whether the policy responds to distinctive local interests.

- Can the underlying rationale of an industry-specific local policy be generalized such that its stated purpose is to allow issuers to raise capital with ease and without the costs associated with preparing a prospectus? If so, then the local interest loses its distinctiveness and the necessity for a local policy may be questionable; a more general national policy that is not industry-specific may serve the local interests.

This part concludes by assessing the relationship of local regulatory initiatives and responses to the issue of distinctive local and regional markets and optimal securities regulatory structure.

(a) *Junior Capital Pool Programs*

Alberta's Junior Capital Pool Program (JCPP)[101] is cited as an example of local regulatory responsiveness to the needs of small businesses and issuers that are at an early stage and need to raise capital from public markets.[102]

This section sets out details of the program and its successes in nurturing and raising capital for small businesses. This section also analyses the program's relationship with local regulation of distinct markets and optimal regulatory structure.

(i) History and Development

The JCPP began in Alberta in 1986. The ASC stated that the objective of the JCPP was as follows:

> The Junior Capital Pool concept is designed to provide junior start up companies with an enhanced opportunity to become listed on The Alberta Stock Exchange thereby providing a viable and efficient mechanism to enable junior companies to raise further equity capital from the investing public. The Exchange recognizes however that as the listing and prospectus disclosure requirements for Junior Capital Pool Companies are substantially less than what is required for other companies, additional requirements are necessary to provide the market with sufficient disclosure and to limit abuse of this system.[103]

In 1997, the BCSC and Vancouver Stock Exchange (VSE) adopted a similar program, the Venture Capital Pool Program (VCPP). When the Alberta Stock Exchange (ASE) and the VSE

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[101] See Alberta Securities Commission Rule 46-501 *Junior Capital Pool Offerings.*

[102] See the submission of the Alberta Securities Commission to the Wise Persons' Committee. See also the submission of DesJardins Ducharme Stein Monast to the Wise Persons' Committee.

[103] M. Robinson, "Raising Equity Capital for Small and Medium-Sized Enterprises Using Canada's Public Equity Markets" in P. Halpern, ed., *Financing Growth in Canada* (1997) 593 at 611.

merged in 1999, forming the Canadian Venture Exchange (CNDX),[104] the JCPP and the VCPP policies were replaced with the Capital Pool Company Policy (CPC Program) of the CDNX. Shortly thereafter, CDNX and the Winnipeg Stock Exchange (WSE) merged, and the WSE's Keystone Company Program (a program similar to the JCPP) was replaced with the CPC Program. Currently, the TSX Venture Exchange operates a CPC Program in B.C., Alberta, Saskatchewan, Manitoba, Ontario and Quebec (collectively known as, the "CPC Jurisdictions"). This program, among other things, assists in harmonizing the ability of entrepreneurs to raise capital in the CPC Jurisdictions.

As a general matter, this initiative was undertaken to provide a financing alternative for early stage firms that would normally raise seed capital privately.

(ii) The Operation of the CPC Program

TSX Venture Exchange Policy 2.4 provides that an issuer, meeting certain requirements, wishing to participate in the CPC Program must file a preliminary prospectus and related supporting documents with the TSX Venture Exchange as well as with each of the relevant securities regulatory authorities in the CPC Jurisdictions where the proposed distribution will be made. Upon issuance of the final receipt and completion of the initial public offering (IPO) (i.e. distribution of shares to at least 200 arm's length shareholders), securities of a CPC issuer will trade on Tier 2 of the TSX Venture Exchange.

A CPC issuer has 18 months following its IPO in which to identify an appropriate business and complete its "Qualifying Transaction", which requires the CPC issuer to seek the approval of both the TSX Venture Exchange and a majority of its minority shareholders prior to completion. In connection with obtaining shareholder approval, the CPC issuer must prepare a comprehensive information circular containing full, true and plain disclosure concerning the CPC issuer's proposed activities.

Following shareholder approval and the closing of the Qualifying Transaction, the CPC issuer transforms into a regular listed issuer on the TSX Venture Exchange.

As of May 30, 2003, there were 145 CPC issuers listed on the TSX Venture Exchange, 59 of which had not announced their Qualifying Transaction.[105]

(iii) Success of the Program

The original JCPP in Alberta was very successful in increasing the access of junior firms to the capital markets to finance their expansions:

- The failure rate by the end of 1992 for JCPP issuers listed on the ASE was just 26%.[106]

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[104] Now known as the TSX Venture Exchange.
[105] See http://www.tse.com/en/pdf/CPCReport.pdf and http://www.tsx.com/en/pdf/TSXVentureCapitalPoolCompanyList.pdf.
[106] *Supra* note 103 at 616.

- Between 1986 and 1992, 405 companies were listed as JCPP issuers, raising over $77 million in initial JCPP offerings.[107]

- Although the number of JCPP issuers had drastically declined in the early 1990's, 99 companies were listed as JCPP companies by 1994.[108]

- Of the 384 JCPP issuers that went public between 1986 and 1992, 86% had completed a major transaction by the end of 1992.

Since the TSX Venture Exchange's adoption of the JCPP, the CPC program has achieved the same successes:

- Between 1987 and 2000, 1,236 CPC issuers listed and raised over $369 million in capital.[109]

- One hundred and twenty-nine new CPC issuers were listed in 2000, raising nearly $40 million.[110]

- Twenty-four percent of TSX Venture Exchange issuers that graduated to the TSX in 2000 are former CPC issuers.[111]

- In 2002, $15.6 million was raised by CPC issuers,[112] 45 CPC issuers were listed on the TSX Venture Exchange,[113] and 37% of TSX Venture Exchange graduates to TSX were former CPC issuers.[114]

(iv) Analysis and Relationship to Optimal Regulatory Structure

The ASC's JCPP is a clear example of responsiveness to the issuer community, in particular by providing smaller issuers with an innovative method to raise public capital as an alternative to private funding.

The fact that the ASC's JCPP was quickly adopted by the BCSC and the VSE, as well as the WSE indicates that it was an extremely positive development that was well regarded by capital market players. Its wider adoption by other provinces suggests, however, that financing for early stage companies is not of unique interest to any one locality or region. In my view, the ASC was not responding to a local or regional issue; the JCPP is an example of regulatory

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107 *Ibid* at 613.
108 *Ibid.*
109 See the Canadian Venture Exchange's CPC Brochure, online at http://www.cdnx.com/Listing/MarketingPubs/CPCBrochure.pdf.
110 *Ibid.*
111 *Ibid.*
112 See the TSX Venture Exchange's CPC Brochure, online at http://www.tse.com/en/pdf/CPCBrochure.pdf.
113 *Ibid.*
114 *Ibid.*

responsiveness to the needs of early stage businesses, a class of issuer that all jurisdictions want to develop and encourage.[115]

The ASC's JCPP is an example of regulatory innovation that may support the case for regulatory experimentation but it is not the product of local or regional market distinctiveness.

In analyzing optimal regulatory structure, the issue is whether alternative regulatory models would be as responsive to the needs of smaller and early stage businesses. Under a USL, the provincial securities regulators would need to achieve consensus to implement such a program, but individual commissions would likely not have the authority to create local rules to implement a program of this type because it does not serve the needs of distinct local markets. Under a Passport Model, each provincial commission would have the authority to create a similar program, and other provincial commissions would have to make a decision as to whether to recognize it. A properly designed single regulator model could have a department that houses expertise and focuses on the needs of smaller and early stage businesses.[116] As discussed in Part 5, a single Canadian regulator could house such expertise in an office similar to the SEC's small business office.

(b) *SHAIF and Multilateral Instrument 45-102 Resale of Securities*

In response to the strict hold-period requirements imposed on certain issuers, the BCSC and the ASC reduced the hold periods for certain securities offerings from twelve months to four months by introducing the System for Shorter Hold Periods for Issuers Filing an AIF (SHAIF System). Their innovation was then adopted by all of the Canadian securities regulators other than Quebec through Multilateral Instrument 45-102 Resale of Securities (MI 45-102).[117]

The SHAIF System reduced the twelve-month hold period to four months if the issuer of the securities was a "qualifying issuer" and had satisfied certain other conditions, including having filed an annual information form (AIF). The SHAIF system reduced the need for special warrant financings, stimulated private placements and provided an alternative option to prospectus financing.

The BCSC developed the SHAIF system on an interim basis in late November 1997 through a policy and blanket order. Working with the ASC, the BCSC fine-tuned the system and together the commissions adopted the SHAIF system in both jurisdictions in 1998. Alberta adopted it by way of local rule.

The adoption of MI 45-102 in November 2001 introduced a new regime for the resale of securities previously issued under exemptions from the prospectus requirements in all Canadian provinces and territories except Quebec.

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115 As stated by the OSC, "Small businesses exist in every province, and they all require capital. Policies which encourage small business investment, publicly or privately, should not be concentrated in one region." See submission by Ontario Securities Commission, *supra* note 83.

116 See the submissions of Ogilvy Renault, the Ontario Bar Association and Discovery Capital Corporation.

117 Online at http://www.bcsc.bc.ca:8080/comdoc.nsf/0/d9c540943f47853b88256cbf0058c1bf/$FILE/MI%2045-102.pdf.

In November 2001, the QSC issued a decision which set out circumstances under which the QSC would permit the resale restrictions applicable to privately placed securities in that province to be reduced from twelve months to four months.[118]

Analysis and Relationship to Optimal Securities Regulatory Structure:

SHAIF is an example of a rule that was created locally but it was not a response to a distinctive local interest. The rule did not focus on any particular local industry. The fact that the rule was rapidly adopted by regulators across the country demonstrates that it had applicability in other provinces as well.

In this instance, the BCSC and the ASC were clearly responsive to the needs of issuers and early stage investors. Both the JCPP and the SHAIF system suggest that there may be a distinct small and medium sized business community and entrepreneurial culture in B.C. and Alberta to which local regulators are particularly sensitive and responsive. However, this is not to say that similar rules and policies could not emerge from a single regulator model, properly designed, so long as it is responsive to the early stage financing needs of small and medium sized issuers.

(c) *National Instrument 51-101 Standards of Disclosure for Oil and Gas Activities*

National Instrument 51-101 (NI 51-101) creates new disclosure standards for oil and gas issuers, including the details of their operations, their compliance, corporate governance requirements, and their reserve reports.[119]

As a result of the ASC's expertise in this industry, the Canadian Securities Administrators (CSA) deferred to the ASC in heading this project.[120] NI 51-101 was approved by the ASC on June 11, 2003.[121] It was developed by the ASC on behalf of the 13 provincial and territorial securities commissions, which together form the CSA. Other CSA members will consider adopting the rule over the next few months.[122]

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118 Decision No. 2001-C-0507.

119 Online at http://www.bcsc.bc.ca:8080/comdoc.nsf/0/9bc2fe07500a096d88256cb8005e882c/$FILE/NI51-101.pdf.

120 As was pointed out by the ASC in its submission to the Wise Persons' Committee, "The ASC's sectoral interest and expertise in the oil and gas sector was recognized by the CSA when it assigned the ASC the lead role in developing the new oil and gas disclosure". Alberta Securities Commission, submission to WPC. See also Discovery Capital Corporation's submission to the Wise Persons' Committee.

121 See http://www.albertasecurities.com/DATA/items/press_rel/0000000713/.pdf.

122 *Ibid.*

Analysis and Relationship to Optimal Securities Regulatory Structure:

The ASC's spearheading of this initiative on behalf of the CSA clearly signals an interprovincial acknowledgement that the ASC has significant expertise in oil and gas issues.

It does not signify that Alberta has a distinctive local interest in oil and gas, as discussed in detail in Part 2. Even though oil and gas issuers may be clustered in Alberta as a part of the LICR, investors are not necessarily resident in Alberta and the industry has national economic significance.

In considering alternatives to the current system, the ASC's leadership on this program underscores the need to preserve the expertise that local regulators have gained as a result of their province hosting an LICR. As well, the strength of the LICR for oil and gas issuers in Alberta suggests the possibility of another regulatory method to rationalize or re-allocate responsibility among commissions such that the ASC would effectively become the "oil and gas securities commission" responsible for all oil and gas issues and other commissions would focus on their area of relative expertise. This model could be based on a similar rationalization process that was undertaken at the level of Canadian stock exchanges, as discussed in Part 4 below.

It should be noted, however, that some larger interlisted oil and gas issuers are of the view that their interests are marginalized in policymaking in respect of the industry. For example, Nexen Inc., a large Canadian-based oil and gas and chemicals company, has stated that NI 51-101 "is geared to smaller Western Sedimentary Basin based companies which presents an entirely new set of problems for inter-listed companies such as Nexen."[123] Nexen's submission to the Wise Persons' Committee suggests that the policy "is a prime example of a 'made-in-Canada' solution that could further marginalize Canada and Canadian issuers from international capital markets" and "reduce the attractiveness of Canadian capital markets to foreign issuers who would be required to comply with NI 51-101" as a result of its different approach to reserves disclosure.

(d) *OSC's Accredited Investor Exemption and Multilateral Instrument 45-103 Capital Raising Exemptions*

Although there has not been a nationally co-ordinated approach to the reform of private placement exemption rules, Multilateral Instrument 45-103 (MI 45-103) follows the implementation of OSC Rule 45-501 – Exempt Distributions (OSC Rule 45-501) by the OSC on November 30, 2001.

OSC Rule 45-501 replaced the most commonly used prospectus exemptions in the *Securities Act* (Ontario)[124] with two new exemptions: the closely-held issuer exemption and the

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[123] See Nexen Inc.'s submission to the Wise Persons' Committee.

[124] These previous exemptions included: the private company exemption; the $150,000 aggregate acquisition cost exemption; and the seed capital exemption. See *Securities Act*, R.S.O. 1990, c. S.5.

accredited investor exemption.[125] The accredited investor exemption contained in of OSC Rule 45-501 is substantially the same as the exemption found in MI 45-103.

The OSC revised its rules in order to make it easier for small businesses to raise start-up capital from the public without being subject to the registration or prospectus requirements of the *Securities Act* (Ontario). These changes responded to a 1996 report of the OSC Task Force on Small Business Financing[126] and a 1999 Ontario budget initiative, both of which called for a simplification of the previous requirements.

According to the OSC, the number and value of investments in small businesses tripled in the 11 months after it relaxed prospectus rules for them. The OSC has indicated that there were 3,528 transactions worth $21 billion in the eleven-month period following the rule change in November 2001, as compared with an average of 1,287 transactions worth just over $6 billion in the years before.[127]

Moreover, the OSC noted that investors were willing to invest more money in a wider range of companies. The most obvious impact was the size of the typical investment. Previously, the most common investment was $150,000, the minimum allowed. After the new rule was implemented, the median investment fell to just $3,000.[128]

After Ontario published its draft private placement rule changes in September 2000, the ASC and BCSC expressed concerns that the new proposals in Ontario were not suitable for small to mid-sized businesses because they contained many limitations and did not address access to middle income investors. As a result, the ASC and BCSC announced in November 2000, a private placement exemption harmonization project.

The new private placement rules were implemented on March 30, 2002 in Alberta and April 3, 2002 in B.C. Since then, MI 45-103 has come into force in each of the remaining

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125 The "accredited investor" exemption permits issuers to raise any amount at any time from any person or company defined as an "accredited investor". These investors are considered to have the capacity to obtain and analyze the information needed to assess an investment opportunity without the assistance provided by a prospectus and to have the financial ability to withstand the loss of the investment. In order to rely on the "accredited investor" exemption, certain requirements must be met: (a) the "accredited investor" must purchase as principal; (b) the investor must be an "accredited investor" listed in Rule 45-501 (the "accredited investor" list includes financial institutions, registered advisors and dealers, governments, pension funds and registered charities125); and (c) most trades to an "accredited investor" require that a Form 45-501FI together with the applicable form, be filed with the OSC within 10 days of the trade together with the applicable fee.

126 Ontario, Ontario Securities Commission, *Ontario Securities Commission Task Force on Small Business Financing – Final Report* (1996).

127 Ontario Securities Commission, News Release, "New Financings More Than Triple to $21 Billion, Benefiting Businesses in Ontario" (April 21, 2003).

128 See Office of the Chief Economist, Ontario Securities Commission, "One Step Forward: A Study of the Economic Impact of OSC Rule 45-501 Exempt Distributions" (2002). See also analysis by Peter Dungan, University of Toronto, Department of Economics, which, based on assumptions specified by the OSC, indicates that the rule change (a) generated 16,500 jobs in 2002 and will generate about 19,400 in 2003, shaving about 0.2 percentage points off the Ontario unemployment rate;(b) raised Ontario's labour productivity by 0.29 percentage points in 2002 and will raise it by a further 0.19 percentage points in 2003; and (c) added $2.63 billion to Ontario's GDP in 2002, and will add $2.42 billion in 2003. *Ibid.*

Canadian provinces and territories, with the exception of Ontario, Quebec, New Brunswick and Yukon.

MI 45-103 contains four exemptions that allow the raising of capital without complying with the registration and prospectus requirements: 1) the private issuer exemption; 2) the family, friends and business associates exemption; 3) the offering memorandum exemption; and 4) the accredited investor exemption.

Analysis and Relationship to Optimal Securities Regulatory Structure:

The OSC's initiative does not represent a response to a distinctive local market or issue. The exemption is not industry specific and other provincial commissions rapidly adopted it. The initiative allows issuers to raise capital in a cost-effective manner without the requirement to prepare a prospectus. As discussed in the JCPP analysis above, alternative models to the current regulatory structure could accommodate such initiatives.

(e) *Saskatchewan Local Policy 45-601 Community Venture Exemption*

The Saskatchewan Securities Commission (SSC) created the Community Venture Exemption in 1993 as Local Policy 45-601 (the "Community Venture Exemption").[129] It allows issuers to raise up to $1 million in a small geographical area of Saskatchewan to fund the creation or development of a "Community Venture" that can provide jobs in, or economic development of, the community.[130] The basis for the exemption is that securities are sold only to local residents involved in the project who do not need a prospectus because of their personal knowledge regarding the issuer and the investment.

While the policy exempts issuers from preparing a prospectus, issuers must provide investors with an offering document. The securities regulators in Saskatchewan have prepared a "fill in the blanks" offering document for this purpose.

The Securities Division of the Saskatchewan Financial Services Commission (SFSC) has indicated that these exemptions have been used successfully by Saskatchewan farmers for the development of local hog farms and grain terminals.[131] Senior staff at the SFSC indicated that more than a dozen large grain terminals in Saskatchewan began their operations using these exemptions, and subsequently conducted prospectus offerings to raise additional capital. The

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[129] This policy came into force on April 2, 1993. This policy replaced Local Policy 5.1, which came into force in 1987 with no substantive changes from the previous policy.

[130] *The Securities Act (1988)* Saskatchewan Policy Statement 45-601, Part 3.

[131] Quadra Investment Group was cited by the SFSC as an example of how issuers can successfully rely on these local exemptions to start up multiple hog farms in Saskatchewan. Quadra would set up a joint venture with local residents and then use the exemptions to raise up to $2 million capital to start up the venture: Interview with Dean Murrison, Acting Deputy Director, Registration, Securities Division, SFSC (July 18, 2003). In November 2000, all of Quadra's 14 hog farms amalgamated into Community Pork Inc., a TSX-listed company. See generally, R. Wright, "Quadra Group and Community Pork Ventures: An Evolution" (2002) (on file with author).

SFSC indicated that the ability to raise inexpensive capital at an early stage in the business cycle of these issuers was directly attributable to these exemptions.

Analysis and Relationship to Optimal Regulatory Structure:

Saskatchewan's Community Venture Exemption is an example of a local rule that appears to respond to distinctive local issues and interests. This local rule has been in existence for several years and, unlike the other local regulatory initiatives analyzed in this part of the study, it has not experienced multilateral or national adoption.

The current regulatory system allows for local regulators to formulate local policies of this sort to respond to local interests. The USL model as proposed by the CSA would also allow for local rules, but only on an exceptional basis. A passport model would presumably also allow provincial commissions to create local rules for local needs.

A single regulator model, in theory, poses the greatest challenge for local rules to be created to respond to distinctive local interests and issues. One can imagine that it would be much more difficult for Saskatchewan farmers to attract the attention of a single regulator than under the current system, where they have (or are perceived to have) a more ready audience with the provincial securities regulator. As a result, a single regulator model may need to allow for a limited role for distinctive local rules by local regulators.

Interestingly, the SFSC is of the opinion that MI 45-103 will likely supersede the Community Venture Exemption.[132] This result is foreseeable given the fact that MI 45-103's offering memorandum exemption is not industry specific and is broad enough to accommodate the financing needs of these issuers.

The SFSC's views on the prospects of the Community Venture Exemption are instructive in determining whether the adoption of a local rule is necessary and whether it responds to a distinctive local market or interest. Is the Community Venture Exemption about the development of a distinctly local industry or economy? In this case, it has assisted in the development of hog farms and grain terminals in Saskatchewan, but Alberta and Manitoba also have hog farms and grain terminals, which suggests that these industries are not a local interest.

Another factor to consider is whether one can reasonably make a generalization that the underlying rationale for the exemption is to allow issuers to raise capital in a cost effective manner. In this case, the fact that many of the hog farms grew and listed on the TSX, suggests that the local aspect of the business may be for a limited period of time, and at some point, the issuer becomes a small-medium sized business, like any other, that is concerned, among other things, about raising capital at low cost.[133] As the SFSC has noted, the more general exemptions in MI 45-103 will likely serve the needs of the local market that has previously been served by this exemption.[134] This above analysis suggests that by generalizing the underlying rationale of

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132 Interview with Dean Murrison, Acting Deputy Director, Registration, Securities Division, SFSC (July 18, 2003).
133 *Ibid.*
134 *Ibid.*

a proposed local rule, a uniform or national rule of broader application might serve as an effective response.

(f) *Relationship to Regulatory Innovation*

Most of the local regulatory responses discussed in this section are not the responses to distinct local and regional markets, although they may support the case for local regulatory innovation and experimentation.

While not central to the objectives of this study, a relevant question in considering optimal regulatory structure is the extent to which alternative regulatory models would produce the same or greater levels of innovation as the current system.

While there is some scope for innovation under the current system because provincial securities regulators can experiment within their own jurisdictions, issuers engaged in interprovincial securities offerings cannot take advantage of innovations that are only available in one province, as they need to comply with the laws of the strictest jurisdiction. Hence, provincial regulators do not have proper incentives to achieve maximum utility for issuers, ex ante, to be innovative on matters that require interprovincial agreement. On the other hand, provincial regulators do have proper incentives to experiment and engage in innovation with respect to early-stage issuers that are engaged in securities activity often entirely within only one province, for example, in the context of prospectus exemptions.

A passport model (either based on issuer headquarters or issuer choice) would allow for greater innovation and experimentation than the current system in all areas of securities regulation because provincial regulators presumably would not need to obtain agreement or consent on specific matters for issuers subject to their jurisdiction to take advantage of innovative products in relation to interprovincial securities activity. However, beyond a certain point, innovation may threaten the base level of harmonization that appears to be necessary for a passport model to operate.

A key assumption that often underlies an assessment of innovation and alternative regulatory models is that "more heads are better than one." Specifically, with respect to achieving the optimal level of innovation, it is often assumed that the greater the number of institutions that analyze an issue, the greater the quality and quantity of ideas that will emerge. However, a single regulator could lead to equal or greater levels of innovation than the current system. The assumption that more heads are better than one and lead to more innovation is not entirely valid in this context. To the extent that LICRs for certain industries exist in more than one province, a single regulator could consolidate that expertise. To the extent that there is no critical mass of issuers in any one locale and hence no clearly identifiable LICR for certain industries, current regulators likely do not have much expertise in those industries and hence are not being innovative in respect of those industries. A single regulator would allow for a consolidation of scattered expertise.

4. Other Developments in Canada Capital Markets

This part analyzes other developments in the Canadian capital markets that affect the analysis of local and regional issues in the determination of optimal regulatory structure.

(a) *Consolidation of Stock Exchanges*

The consolidation of stock exchanges in Canada reveals a great deal about the power of globalization and market forces in re-shaping the capital markets framework in Canada.[135] The merger of five regional stock exchanges into three, each with specialized expertise, suggests that the capital markets in Canada are increasingly national, as opposed to regional, in character.[136] These market forces might propel a similar rationalization of the securities regulatory structure in Canada at the level of the securities commissions.

The merger of the VSE and the ASC into the CDNX in 1999 may provide some useful lessons for reform at the securities regulator level.

Stakeholders have different views on the success of this merger. Some stakeholders were of the view that the merger of the two exchanges was successful. They were pleased with the flexibility and the discretion that local offices were given to interpret and apply the CDNX rule book (which involved a merger of the rule books of the VSE and the ASE) differently in the two offices of the exchange (Vancouver and Calgary) based on the different issuer base (mining versus oil and gas) and the different regulatory concerns that each industry presents.

Other stakeholders were of the view that the merger of the stock exchanges was rash and that the rule books were poorly integrated. They expressed the concern that the rule book is being administered differently in the Vancouver office as compared to the Calgary office. These stakeholders suggested that more time and thought should have been put into the merger prior to it taking place, but recognized that these issues will likely resolve themselves over time.

The main lesson to be learned from the merger of the VSE and ASE for the current debate on optimal regulatory structure at the level of securities commissions is that the possibility of varying application at the local level of uniform national rules must be acknowledged or addressed.

(b) *The Role of the CSA and the Uniform Securities Legislation Project*

This section describes the role of the CSA, its initiatives in respect of harmonization, and the Uniform Securities Legislation Project (USL Project).

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135 For a history of the stock exchange rationalization process in Canada, see Appendix C.

136 In its submission to the Wise Persons' Committee, the TSX Group notes that "the broader secular changes that have created this new situation essentially involve new global imperatives insinuating themselves into a market governed within the bounds of a regulatory framework that was and is primarily local in its preoccupations." TSX Group Inc., submission to WPC. The Canadian Bankers Association stated in this regard: "the market recognized the need for economies of scale in the face of international competition and regulators allowed the needed changes to take place." Canadian Bankers Association, submission to WPC.

The CSA is an umbrella organization representing the 13 provincial and territorial securities commissions. It is an informal body that functions through meetings, conference calls and day-to-day cooperation among its members. Funding and support comes from the member commissions on a voluntary basis. The CSA's purpose is to coordinate and harmonize regulation of the Canadian capital markets.[137] Its mission is to foster fair and efficient capital markets while protecting investors from unfair, improper and fraudulent practices.[138] Even though the CSA is criticized as being slow and inefficient, its initiatives in respect of coordination and harmonization to date have been quite significant.[139]

The CSA's USL Project was initiated in 2001 and is scheduled to be ready for adoption across Canada by 2004. The project is part of a broader CSA strategy that aims to: 1) reduce the regulatory burden on market participants; and 2) make regulation more effective in protecting investors and market integrity.[140]

The objective of the USL Project is to eliminate the differences in provincial and territorial securities laws by developing a uniform act and uniform rules for adoption by each jurisdiction of Canada.[141]

The CSA's Blueprint states: "Since the USL Project is a harmonization initiative, the resulting Uniform Act and Uniform Rules would contain few substantive differences from current securities laws."[142] However, the CSA's USL allows for local rules that take into account local markets. The Blueprint states:

> Where a harmonized approach may not be appropriate, the majority position would be set out in the Uniform Act and Uniform Rules. Local differences would be set out by way of exceptions in a local provincial or territorial rule (Local Rule) or the relevant Administration Act, [anticipating] that the use of Local Rules would be exceptional and infrequent. Local Rules would be reviewed regularly to ensure that they reflect obvious local needs rather than theoretical differences.[143]

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137 The CSA coordinates securities regulation initiatives on a national scale, leaving enforcement and complaint handling to provincial and territorial jurisdiction. As noted on the CSA website at http://www.csa-acvm.ca/html_CSA/about_who_are_csa.html, "this provides a more direct and efficient service since each regulator is closer to its local investors and market participants."

138 See http://www.csa-acvm.ca/pdfs/CSA_Strategic_Plan-2002.pdf.

139 See *Blueprint for Uniform Securities Law for Canada* (Canadian Securities Administrators, 2003), online at http://www.gov.ns.ca/nssc/docs/conceptproposal.pdf. CSA has developed: national instruments and national policies in areas including prospectus requirements, mutual fund regulation, rights offerings, take-over bids, and marketplace operations; the Mutual Reliance Review System ("MRRS") for prospectus vetting and exemptive relief; the System for Electronic Document Analysis and Retrieval ("SEDAR"), which makes available on the Internet public documents filed by reporting issuers; the National Registration Database ("NRD"), a web-based system that allows dealers and advisors to file registration forms electronically; and the System for Electronic Disclosure by Insiders ("SEDI"), a central electronic system for insider reporting that was made operational in May, 2003.

140 *Blueprint*, *supra* note 139.

141 *Ibid.*

142 *Ibid.*

143 *Ibid.*

The Blueprint does not state what appropriate local rules would be and why they would be necessary. The factors that were set out in Part 4 above to determine whether a local rule is necessary and responds to a distinct local interest or market ought to be used in this analysis.

Even though local regulators claim that mining is a local concern, it is telling that the Prospectors and Developers Association of Canada (PDAC), the national association for the mining industry, is not in favour of the concept of local rules. It states:

> In our submissions on the draft USL legislation, we disagreed with the need for local rules. Local Rules should not be permitted to change the substantive provisions of securities legislation. Issuers need to be able to look to one source to determine the relevant securities regime across the country. Having to check in each case for Local Rules would result in complication, delay and expense.[144]

PDAC appears to be arguing that the benefits of any local rules would be outweighed by the costs incurred by issuers (and ultimately passed down to investors) in complying with multiple sources of regulation.

(c) *BCSC's Deregulation Project: New Proposals for Securities Regulation*[145]

The BCSC has initiated a two-year project with the aim of streamlining and simplifying the B.C. *Securities Act* as a response to the provincial Liberal government's call for all government bodies to reduce their regulations by one-third.[146]

BCSC Chair Douglas Hyndman has identified three sources of regulatory burden: (1) differences in regulatory requirements among jurisdictions; (2) separate decision-making processes in each jurisdiction; and (3) the volume and complexity of regulatory requirements.[147] He notes that the current national focus on addressing the first two issues has negatively affected the third issue. The BCSC's response in the form of a deregulation project is aimed at making regulation less complex and burdensome and more effective in achieving the goals of investor protection and market integrity.[148]

The BCSC discussion paper, *New Proposals for Securities Regulation* proposes key changes in respect of continuous market access (CMA), registration, investor remedies and

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144 Presentation on the Inter-Provincial Securities Initiative by the Prospectors and Developers Association of Canada, online at http://www.pdac.ca/pdac/sr/030715.html.

145 See *New Proposals for Securities Regulation* (Vancouver: British Columbia Securities Commission, 2002) at 69.

146 British Columbia Securities Commission Annual Report 2001-02, online at http://www.gov.bc.ca/cas/down/2001_02_annual_reports/bcsc_ar_2001_02.pdf.

147 Speech dated October 9, 2002, online at http://www.bcsc.bc.ca/Publications/Hyndman_EconomicClub.pdf.

148 *Ibid.*

enforcement and public interest powers.[149] The BCSC is also proposing ways to simplify the province's mutual fund regulation.

The BCSC Deregulation Project was undertaken in conjunction with the USL project described in the preceding section. While the BCSC proposed that its changes be adopted nationally by all provincial securities commissions, the other CSA members appear to have rejected the proposal for now.

The policy goals of the BCSC's proposals are certainly laudable,[150] but the proposals appear to contradict the CSA's USL project, because the BCSC's implementation of its proposals will result in a wider divide in regulatory requirements between jurisdictions. The BCSC CMA model does present an "interface" for issuers that wish to conduct inter-provincial offerings such that the BCSC will recognize compliance with the laws of a foreign jurisdiction (which includes other Canadian provinces) for the purpose of compliance with the B.C. system so that issuers will not have to comply with inconsistent regulatory requirements.[151]

However, other provincial commissions have yet to indicate that they will recognize the B.C. proposed model. Until they do, issuers will only benefit from the cost savings associated with CMA if they engage in an exclusively intra-provincial offering (with both the issuer being headquartered in B.C. and all investors being located in B.C.) or wait until all provincial securities commission adopt or recognize B.C.'s CMA model.

Chair Douglas Hyndman and his senior staff emphasized that the proposals are not a regulatory response to distinct local or regional markets.[152] They emphasized that the proposals are a "top-down" initiative based on the BCSC's view of how securities markets should be regulated. The fact that the BCSC invited other securities commissions to participate in the new framework, and that other provincial regulators acknowledged that the proposals had some merit,[153] (although they decided that their priorities in respect of securities regulatory reform lay elsewhere) also suggests that the proposals are not a local regulatory initiative in response to distinct local markets or issues.

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149 The concepts were based on five guiding principles: (1) keep the right balance between regulatory restrictions and market freedom; (2) make the rules as simple and clear as possible; (3) foster a culture of compliance in industry; (4) act decisively against misconduct; and (5) equip investors with self-protection tools. See also http://www.share.ca/files/newsletters/prospectus3.pdf.

150 The Investment Dealers Association of Canada has voiced its support of the B.C. proposals, stating that "The BCSC initiative stands out by recognizing that improved disclosure, the harmonization of rules across provincial jurisdictions and tougher enforcement can be achieved not only through fewer and better-focused rules, but by shifting emphasis to the judicial and quasi-judicial system to impose a discipline on market participants." Investment Dealers Association of Canada, submission to WPC. Also, Discovery Capital Corporation commented in its submission to the Wise Persons' Committee that Canadian securities regulation must tolerate the testing of innovative regulatory solutions, such as the B.C. model, on a pilot basis within regions. Discovery Capital Corporation, submission to WPC.

151 *New Proposals for Securities Regulation*, *supra* note 145, at 70-72.

152 Meeting with BCSC Chair Douglas Hyndman and his senior staff on June 16, 2003.

153 See Letter from D. Brown to D. Hyndman (27 June 2003), online at http://www.osc.gov.on.ca/en/About/News/Speeches/spch_20030627_brown-re-bcsc.pdf.

While the B.C. proposal is not a response to distinct local markets, it may be an example of regulatory innovation that may ultimately be adopted or recognized by other provincial commissions, not unlike the other regulatory initiatives discussed in Part 4.

5. The U.S. Approach

This part highlights the approach of the SEC in addressing local and regional issues in its securities regulatory structure. In particular, this part highlights the roles and responsibilities of the SEC's district and regional offices as well as the mandate of the SEC's small business office. This part does not focus on the issue of federal-state interaction in respect of securities regulation, which is dealt with in detail by Professor Joel Seligman in a separate study commissioned by the Wise Persons' Committee.[154]

(a) *District and Regional Offices*

Aside from its Washington, DC headquarters, the SEC has 10 regional and district offices throughout the country.[155] The four regional offices report up to the different divisions at the headquarters in Washington. The SEC's six district offices report to four regional offices. Approximately 1400 staff members work at the regional and district offices, which represents approximately one-third of the SEC's total staff.[156]

The regional and district offices are primarily responsible for enforcement (including the investigation of securities fraud and cases involving market intermediaries) and examination (of market intermediaries such as investment dealers and investment advisors.) These two responsibilities are split about evenly in most regional offices.[157] The regional offices do about 95% of the SEC's examinations and inspections work, and about 70% of the SEC's enforcement work.

In completing their work, regional office staff work in teams that include staff from SEC headquarters. As well, regional office staff work closely with self-regulatory organizations (SROs) such as the National Association of Securities Dealers (NASD).

The regulation of stock exchanges, however, is primarily handled by SEC staff at headquarters, with secondary assistance from the regional offices. For example, in overseeing the New York Stock Exchange (the NYSE), senior examiners from the Northeast Regional Office in New York City assist staff from SEC's Washington headquarters.[158]

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[154] Joel Seligman, "The United States Federal-State Model of Securities Regulation" (WPC Research Study, 2003).

[155] See Appendix D.

[156] Interview with Jim Clarkson, Director, Regional Office Assistance and Program Management, Securities and Exchange Commission and Elizabeth Jacobs, Assistant Director. Office of International Affairs, Securities and Exchange Commission (July 28, 2003).

[157] *Ibid.*

[158] *Ibid.*

The Division of Enforcement[159] in Washington oversees the enforcement activities of the regional offices. The Director of the Division of Enforcement decides on priorities, which are communicated to the regional office heads at regular meetings.[160] The heads of the regional office provide input on issues that are indigenous to their regions.

In respect of enforcement, all staff must obtain the approval of a five-member commission[161] prior to commencing an investigation or filing an action. All staff must also obtain the approval of this commission prior to settlement of any action that is being settled for less than the full remedy that was sought.

Prior to appearing before the five-member commission, “action memos” must be sent to the “Office of the General Counsel”[162] which ensures that the file is consistent with the direction that the Commissioners are taking. Staff from the Office of the General Counsel is responsible for particular regional offices, and build relationships with those offices.[163]

Once an investigation begins, it is under the control of the regional or district office. These offices are responsible for taking testimony, negotiating settlements, and so forth. As a result, the offices have a great deal of autonomy for investigation and enforcement and can do a lot of work without approval or authorization from the SEC’s headquarters.[164]

In respect of examinations, the Office of Compliance Inspections and Examinations[165] (OCIE) serves the same role as the Division of Enforcement at SEC headquarters. This division develops national policies for the regional offices. At the beginning of the year, senior staff from the OCIE meet with senior staff of the regional offices to develop priorities.[166]

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159 The Division of Enforcement investigates possible violations of securities laws, recommends Commission action when appropriate, either in a federal court or before an administrative law judge, and negotiates settlements on behalf of the Commission. While the SEC has civil enforcement authority only, it works closely with various criminal law enforcement agencies throughout the country to develop and bring criminal cases when the misconduct warrants more severe action. See http://www.sec.gov/divisions/enforce.shtml.

160 Interview with Jim Clarkson and Elizabeth Jacobs, *supra* note 156.

161 See http://www.sec.gov/about/commissioner.shtml.

162 The General Counsel is the chief legal officer of the Commission. Primary duties of the Office include representing the SEC in certain civil, private, or appellate proceedings, preparing legislative material, and providing independent advice and assistance to the Commission, the Divisions, and the Offices. Through its amicus curiae program, the Office often intervenes in private appellate litigation involving novel or important interpretations of the securities laws. See http://www.sec.gov/about/whatwedo.shtml#org.

163 Interview with Jim Clarkson and Elizabeth Jacobs, *supra* note 156.

164 *Ibid.*

165 The Office of Compliance Inspections and Examinations administers the SEC's nationwide examination and inspection program for registered self-regulatory organizations, broker-dealers, transfer agents, clearing agencies, investment companies, and investment advisers. The Office conducts inspections to foster compliance with the securities laws, to detect violations of the law, and to keep the Commission informed of developments in the regulated community. Among the more important goals of the examination program is the quick and informal correction of compliance problems. When the Office finds deficiencies, it issues a "deficiency letter" identifying the problems that need to be rectified and monitor the situation until compliance is achieved. Violations that appear too serious for informal correction are referred to the Division of Enforcement. See http://www.sec.gov/about/whatwedo.shtml#org.

166 Interview with Jim Clarkson and Elizabeth Jacobs, *supra* note 156.

SEC headquarters reviews regional examination reports for the purposes of quality control, but regional offices have autonomy in conducting examinations, writing reports and making deficiency reports, if necessary.[167]

There are "subject matter experts" in Washington who provide guidance and counsel in respect of legal questions. Policy work is finalized in Washington, but in drafting rules, Washington seeks the input of the regional offices.[168]

Regional and district offices interact frequently with the state securities commissioners. They share information, send and receive enforcement referrals and meet regularly during the year. At these meetings, the SEC hears the state regulators' concerns and conveys its own regulatory and enforcement concerns.[169] For examinations, joint "exam summits" take place at which senior state examination officers, SROs and regional office examination staff discuss the examination of market intermediaries and develop coordinated sweeps.

Regional and district offices house regional regulatory expertise. For example, the Boston and Philadelphia District Offices focus on the investment management industry and receive a disproportionate share of the SEC's resources devoted to regulating the investment management industry, due to the very large population of investment management that takes place in those cities.[170]

Hiring for regional and district offices is done locally, and local offices have authority to emphasize recruiting and hiring in industries that are important to that region.[171]

Local and regional offices do not review corporate filings. Washington headquarters handles review of corporate filings.[172]

Most regional offices were established at the same time that the SEC was created. The key rationale for setting them up was that SEC staff should be physically close to the firms that they are regulating and to the state authorities with which they work. The SEC has, on occasion, closed certain offices and expanded others, based on changing workloads and priorities.[173]

(b) *The SEC's Small Business Office*

The SEC has undertaken several initiatives to be responsive to the needs of small businesses. Most importantly, the SEC has created a unit entitled the Office of Small Business, a unit that is under the control of the Corporate Finance division. This unit, housed in Washington D.C., specializes in small company filings and the needs of small businesses, including crafting

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167 *Ibid.*
168 *Ibid.*
169 See also, H.H. Mackens, "An American State-Federal Perspective on the Proposals" (1981) 19 Osgoode Hall Law Journal 424 at 428.
170 Interview with Jim Clarkson and Elizabeth Jacobs, *supra* note 156.
171 *Ibid.*
172 *Ibid.*
173 *Ibid.*

rules to lessen the burden of the SEC's regulation on these issuers.[174] The SEC's definition of "small business" includes firms with less than $5 million in net assets. [175]

The SEC's website also has a section devoted to providing guidance to small issuers, which contains the text of a number of forms and regulations of interest to smaller issuers. [176]

Since 1996, the SEC has also held a number of town hall meetings with small businesses throughout the United States. These meetings convey basic information to small businesses about raising capital through public markets. These meetings also allow the SEC to learn more about the concerns and problems facing small businesses in raising capital so that programs can be designed to meet their needs.

The SEC also participates in the annual Government-Business Forum on Small Business Capital Formation, mandated by the *Small Business Investment Incentive Act of 1980*. [177] It is the only government-sponsored national conference for smaller issuers, and offers a yearly opportunity for small businesses to provide government officials with input on how regulatory requirements affect their ability to raise capital. Past conferences have developed numerous recommendations for legislative and regulatory changes in the areas of taxation, securities and financial services regulation and state and federal assistance.

At the 2003 Government-Business Forum, the corporation finance working group discussed the impact of the *Sarbanes-Oxley Act of 2002*[178] on small companies.[179] What emerged from the conference is that small companies may be less inclined to pursue public offerings or voluntarily register as public companies, given the increased cost of compliance with the new rules. As well, compliance with the new rules might be too burdensome for currently reporting smaller companies given their more limited resources. As a result of the concerns expressed, the SEC staff noted that there was a need to monitor and assess the impact of the new rules on the small business community.

6. Conclusion

This study finds that LICRs exist for certain industries and levels of market capitalization. This study finds that Alberta hosts an LICR for oil and gas, B.C. hosts an LICR for micro-cap issuers, and Ontario hosts an LICR for financial services. Certain LICRs exist in more than one province: Both B.C. and Ontario host LICRs for mining; Ontario, Quebec and B.C. for communications and media; Ontario and Quebec for life sciences; and B.C., Alberta and Ontario each host an LICR for small cap issuers.

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174 United States, *Securities and Exchange Commission* (2000) at 23-24, online at http://www.sec.gov/pdf/cfcr112k.pdf.
175 See Letter from U.S. Small Business Administration's Office of Advocacy to J. Katz (August 19, 2002).
176 Online at http://www.sec.gov/info/smallbus/qasbsec.htm.
177 Online at http://www.sec.gov/info/smallbus/sbforum.shtml.
178 *The Sarbanes-Oxley Act of 2002*, H.R. 3763.
179 United States, *Final Report: 2003 Conference on Federal-State Securities Regulation* (2003) at 2-3.

However, the existence of LICRs for certain industries does not allow us to conclude that the economic activity associated with these industries is local to host provinces or that host provinces have distinct local interests in the capital markets regulation or general regulation of those industries.

The activities of issuers concentrated within an LICR have an impact outside the geographic boundaries of the province that hosts and regulates the LICR. Other provinces may have an interest equal to that of the regulating province, given investor location and the importance of those industries to the economies of other provinces, as borne out by GDP data.

Having found that LICRs for certain industries and levels of market capitalization exist in Canada, the issue that follows is whether provincial securities commissions that host an LICR identified in this study are responsive to that infrastructure in a manner that is different than other provincial securities commissions that do not host that LICR.

The Saskatchewan Community Venture Local Policy may be a legitimate example of a local policy serving distinct local needs and hence, underscore may support the importance of provincial regulation of distinctive local and regional markets. However, most locally-developed policies and regulatory approaches examined in this study have experienced relatively rapid multilateral or national adoption. In addition, most locally- developed policies studied in this report have been (a) in relation to industries that are national, not local, in character; (b) in response to concerns of investors located throughout the country; and (c) industry-neutral rules that allow issuers to raise capital in a cost-effective manner.

Overall, the analysis in this study finds that the majority of local regulatory responses are not the product of local and regional distinctiveness. As a result, the main conclusion to be drawn from the study is that existing local and regional differences can be accommodated under different regulatory models without appreciable differences in regulatory outcomes.

Appendix A – The Decomposition of Gross Domestic Product by Province

Table 1a – The Decomposition of GDP in Alberta

	1997 Constant Dollars	Percent of Total
GDP of Alberta (Millions of Dollars)		
1. Agriculture, Forestry, Fishing, and Hunting	$2,294	1.9%
2. Mining and Oil and Gas Extraction	$20,527	17.1%
3. Utilities	$2,881	2.4%
4. Construction	$9,461	7.9%
5. Manufacturing	$11,204	9.3%
6. Wholesale and Retail Trade	$12,667	10.6%
7. Transportation and Warehousing	$6,601	5.5%
8. Information and Cultural Industries	$4,408	3.7%
9. Finance, Insurance, Real Estate and Renting	$20,361	17.0%
10. Educational Services	$4,605	3.8%
11. Healthcare and Social Assistance	$4,920	4.1%
12. Public Administration	$4,892	4.1%
13. Arts, Entertainment, and Recreation	$773	0.6%
14. Administrative and Support Services	$1,987	2%
15. Professional, Scientific, and Technical Services	$6,385	5%
16. Other Services	$6,079	5%
TOTAL	$120,046	100%

Table 1b – The Decomposition of GDP in British Columbia

	1997 Constant Dollars	Percent of Total
GDP of British Columbia (Millions of Dollars)		
1. Agriculture, Forestry, Fishing, and Hunting	$4,367	4%
2. Mining and Oil and Gas Extraction	$3,203	3%
3. Utilities	$2,507	2%
4. Construction	$5,804	5%
5. Manufacturing	$12,249	10%
6. Wholesale and Retail Trade	$13,418	11%
7. Transportation and Warehousing	$6,763	6%
8. Information and Cultural Industries	$5,446	5%
9. Finance, Insurance, Real Estate and Renting	$27,144	23%
10. Educational Services	$6,120	5%
11. Healthcare and Social Assistance	$7,898	7%
12. Public Administration	$6,195	5%
13. Arts, Entertainment, and Recreation	$1,329	1%
14. Administrative and Support Services	$2,321	2%
15. Professional, Scientific, and Technical Services	$5,009	4%
16. Other Services	$7,116	6%
TOTAL	$116,888	100%

Table 1c – The Decomposition of GDP in Northwest Territories (N.W.T.)

	1997 Constant Dollars	Percent of Total
GDP of N.W.T. (Millions of Dollars)		
1. Agriculture, Forestry, Fishing, and Hunting	$12	0.4%
2. Mining and Oil and Gas Extraction	$766	28.3%
3. Construction	$584	21.6%
4. Utilities	$38	1.4%
5. Manufacturing	$9	0.3%
6. Wholesale and Retail Trade	$184	6.8%
7. Transportation and Warehousing	$149	5.5%
8. Finance, Insurance, and Real Estate	$325	12.0%
9. Healthcare and Social Assistance	$107	3.9%
10. Public Administration	$330	12%
11. Other Services	$201	7.4%
TOTAL	$2,704	100%

Table 1d – The Decomposition of GDP in Newfoundland

	1997 Constant Dollars	Percent of Total
GDP of Newfoundland (Millions of Dollars)		
1. Agriculture	$412	3.3%
2. Forestry and Logging	99	0.8%
3. Fishing and Trapping	$247	2.0%
4. Mining and Oil Extraction	$2,255	17.9%
5. Manufacturing	$724	5.7%
6. Construction	$567	4.5%
7. Utilities	470	3.7%
8. Wholesale and retail trade	$1,252	9.9%
9. Transportation and Warehousing	$467	4%
10. Finance, Insurance, Real Estate, Renting and Leasing	1,920	15.2%
11. Educational Services	$784	6.2%
12. Healthcare and Social Assistance	$1,024	8.1%
13. Public Administration	$1,102	8.7%
14. Information and Cultural	$598	4.7%
15. Other Services	$688	5.5%
TOTAL	$12,609	100%

Table 1e – The Decomposition of GDP in Saskatchewan

	1997 Constant Dollars	Percent of Total
GDP of Saskatchewan (Millions of Dollars)		
1. Agriculture, Forestry, Fishing, and Hunting	$1,742	6%
2. Mining and Oil and Gas Extraction	$4,006	14%
3. Manufacturing	$2,054	7%
4. Construction	$1,239	4%
5. Transportation, Warehousing and Utilities	$2,485	9%
6. Wholesale and Retail Trade	$3,245	12%
7. Finance, Insurance, Real Estate, and Renting and Leasing	$4,843	17%
8. Information and Cultural industries	$1,009	4%
9. Education, Healthcare, and Social Assistance	$3,293	12%
10. Public Administration	$1,693	6%
11. Other Service Industries	$2,506	9%
TOTAL	$28,114	100%

Table 1f – The Decomposition of GDP in Ontario

	1997 Constant Dollars	Percent of Total
GDP of Ontario (Millions of Dollars)		
1. Agriculture	$4,510	1%
2. Forestry and Logging	$874	0.2%
3. Fishing and Trapping	$16	0.0%
4. Mining and Oil Extraction	$2,952	1%
5. Utilities	$10,460	3%
6. Construction	$20,779	5%
7. Manufacturing	$83,849	20%
8. Wholesale and Retail Trade	$50,688	12%
9. Transportation and Warehousing	$15,756	4%
10. Information and Cultural	$19,665	5%
11. Finance, Insurance, and Real Estate	$88,628	22%
12. Health and Education	$40,422	10%
13. Other Services	$72,982	18%
TOTAL	$411,581	100%

Table 1g – The Decomposition of GDP in Quebec

	1997 Constant Dollars	Percent of Total
GDP of Quebec (Millions of Dollars)		
1. Agriculture, Forestry, Fishing and Hunting	$3,787	2%
2. Mining and Oil and Gas Extraction	$1,587	1%
3. Utilities	$8,802	4%
4. Construction	$10,763	5%
5. Manufacturing	$45,213	21%
6. Wholesale and Retail Trade	$24,448	11%
7. Transportation and Warehousing	$9,395	4%
8. Information and Cultural	$10,991	5%
9. Finance, Insurance, Real Estate, Renting and Leasing	$36,877	17%
10. Health and Education	$22,987	11%
11. Other Services	$38,953	18%
TOTAL	$213,803	100%

Source: Statistics Canada – CANSIM

Appendix B – Regional and Sectoral Representation of Canadian Issuers

Table 1a – Regional and Sectoral Representation of TSX-Listed Issuers

	Total	Alberta	Percentage of Sectoral Total	British Columbia	Percentage of Sectoral Total	Manitoba	Percentage of Sectoral Total	New Brunswick	Percentage of Sectoral Total
Total	**1222**	**233**		**177**		**24**		**2**	
Communications and Media	**67**	5	7%	6	9%	3	4%	0	0%
Percent of Provincial Total		2%		3%		13%		0%	
Diversified Industries	**339**	57	17%	40	12%	8	2%	1	0%
Percent of Provincial Total		24%		23%		33%		50%	
Financial Services	**243**	16	7%	5	2%	9	4%	1	0%
Percent of Provincial Total		7%		3%		38%		50%	
Forest Products	**26**	0	0%	12	46%	1	4%	0	0%
Percent of Provincial Total		0%		7%		4%		0%	
Life Sciences	**73**	5	7%	14	19%	2	3%	0	0%
Percent of Provincial Total		2%		8%		8%		0%	
Mining	**159**	5	3%	63	40%	0	0%	0	0%
Percent of Provincial Total		2%		36%		0%		0%	
Oil & Gas	**123**	113	92%	5	4%	0	0%	0	0%
Percent of Provincial Total		48%		3%		0%		0%	
Real Estate	**41**	10	24%	7	17%	0	0%	0	0%
Percent of Provincial Total		4%		4%		0%		0%	
Technology	**128**	10	8%	24	19%	1	1%	0	0%
Percent of Provincial Total		4%		14%		4%		0%	
Utilities and Pipelines	**23**	12	52%	1	4%	0	0%	0	0%
Percent of Provincial Total		5%		1%		0%		0%	

Source: Raw Data from Toronto Stock Exchange (at May 31, 2003)

[180] Certain columns and/or rows in Appendix B tables may not add up to 100% because foreign issuers headquartered outside of Canada are not represented on the tables.

Table 1a – Regional and Sectoral Representation of TSX-Listed Issuers (Continued)

	Newfoundland	Percentage of Sectoral Total	Northwest Territories	Percentage of Sectoral Total	Nova Scotia	Percentage of Sectoral Total	Ontario	Percentage of Sectoral Total	Quebec	Percentage of Sectoral Total	Saskatchewan	Percentage of Sectoral Total
Total	**6**		**1**		**18**		**577**		**177**		**7**	
Communications and Media	1	1%	0	0%	3	4%	31	46%	18	27%	0	0%
Percent of Provincial Total	17%		0%		17%		5%		10%		0%	
Diversified Industries	3	1%	1	0%	6	2%	155	46%	65	19%	3	1%
Percent of Provincial Total	50%		100%		33%		27%		37%		43%	
Financial Services	1	0%	0	0%	2	1%	193	79%	16	7%	0	0%
Percent of Provincial Total	17%		0%		11%		33%		9%		0%	
Forest Products	0	0%	0	0%	0	0%	4	15%	9	35%	0	0%
Percent of Provincial Total	0%		0%		0%		1%		5%		0%	
Life Sciences	0	0%	0	0%	0	0%	27	37%	25	34%	0	0%
Percent of Provincial Total	0%		0%		0%		5%		14%		0%	
Mining	0	0%	0	0%	2	1%	68	43%	18	11%	3	2%
Percent of Provincial Total	0%		0%		11%		12%		10%		43%	
Oil & Gas	0	0%	0	0%	0	0%	3	2%	1	1%	1	1%
Percent of Provincial Total	0%		0%		0%		1%		1%		14%	
Real Estate	0	0%	0	0%	3	7%	19	46%	2	5%	0	0%
Percent of Provincial Total	0%		0%		17%		3%		1%		0%	
Technology	0	0%	0	0%	0	0%	74	58%	19	15%	0	0%
Percent of Provincial Total	0%		0%		0%		13%		11%		0%	
Utilities and Pipelines	1	0%	0	0%	2	9%	3	13%	4	17%	0	0%
Percent of Provincial Total	17%		0%		11%		1%		2%		0%	

Table 1b – Regional and Sectoral Representation of TSX Venture Exchange-Listed Issuers

	Total	Alberta	Percentage of Sectoral Total	British Columbia	Percentage of Sectoral Total	Manitoba	Percentage of Sectoral Total	New Brunswick	Percentage of Sectoral Total
Total	**2,041**	**440**		**983**		**18**		**6**	
Communications and Media	**29**	5	17%	14	48%	0	0%	0	0%
Percent of Provincial Total		0%		1%		0%		0%	
Diversified Industries	**335**	81	24%	111	33%	3	1%	3	1%
Percent of Provincial Total		4%		11%		17%		50%	
Financial Services	**81**	17	21%	25	31%	2	2%	0	0%
Percent of Provincial Total		1%		3%		11%		0%	
Forest Products	**1**	0	0%	1	100%	0	0%	0	0%
Percent of Provincial Total		0%		0%		0%		0%	
Mining	**918**	77	8%	584	64%	6	1%	1	0%
Percent of Provincial Total		4%		59%		33%		17%	
Oil & Gas	**282**	173	61%	89	32%	1	0%	0	0%
Percent of Provincial Total		8%		9%		6%		0%	
Real Estate	**61**	22	36%	16	26%	2	3%	1	2%
Percent of Provincial Total		1%		2%		11%		17%	
Technology	**324**	62	19%	139	43%	4	1%	1	0%
Percent of Provincial Total		3%		14%		22%		17%	
Utilities and Pipelines	**10**	3	30%	4	40%	0	0%	0	0%
Percent of Provincial Total		0%		0%		0%		0%	

Table 1b – Regional and Sectoral Representation of TSX Venture Exchange-Listed Issuers (Continued)

	Newfoundland	Percentage of Sectoral Total	Northwest Territories	Percentage of Sectoral Total	Nova Scotia	Percentage of Sectoral Total	Ontario	Percentage of Sectoral Total	Quebec	Percentage of Sectoral Total	Saskatchewan	Percentage of Sectoral Total
Total	**9**		**1**		**16**		**415**		**142**		**11**	
Communications and Media	0	0%	0	0%	0	0%	9	31%	1	3%	0	0%
Percent of Provincial Total	0%		0%		0%		2%		1%		0%	
Diversified Industries	1	0%	1	0%	0	0%	101	30%	31	9%	3	1%
Percent of Provincial Total	11%		100%		0%		24%		22%		27%	
Financial Services	0	0%	0	0%	1	1%	32	40%	4	5%	0	0%
Percent of Provincial Total	0%		0%		6%		8%		3%		0%	
Forest Products	0	0%	0	0%	0	0%	0	0%	0	0%	0	0%
Percent of Provincial Total	0%		0%		0%		0%		0%		0%	
Mining	7	1%	0	0%	5	1%	168	18%	66	7%	4	0%
Percent of Provincial Total	78%		0%		31%		40%		46%		36%	
Oil & Gas	1	0%	0	0%	4	1%	12	4%	1	0%	1	0%
Percent of Provincial Total	11%		0%		25%		3%		1%		9%	
Real Estate	0	0%	0	0%	2	3%	13	21%	4	7%	1	2%
Percent of Provincial Total	0%		0%		13%		3%		3%		9%	
Technology	0	0%	0	0%	4	1%	78	24%	34	10%	2	1%
Percent of Provincial Total	0%		0%		25%		19%		24%		18%	
Utilities and Pipelines	0	0%	0	0%	0	0%	2	20%	1	10%	0	0%
Percent of Provincial Total	0%		0%		0%		0%		1%		0%	

Source: Raw Data from TSX Venture Exchange (at July 7, 2003)

Table 1c – Market Capitalization of TSX-Listed Issuers

	Total	Alberta	Percentage of Sectoral Total	British Columbia	Percentage of Sectoral Total	Manitoba	Percentage of Sectoral Total	New Brunswick	Percentage of Sectoral Total	Newfoundland	Percentage of Sectoral Total
Total	**$922,994,659,202**	177,789,567,775		45,229,873,133		30,232,642,383		275,722,708		2,063,467,490	
Communications and	100,550,211,465	4,062,445,514	4%	7,620,397,323	8%	3,177,706,260	3%	0	0%	88,397,919	0%
Percent of Provincial Total		2%		17%		11%		0%		4%	
Number of Issuers	67	5		6		3		0		1	
Avg. Market Cap/Issuer	1,500,749,425	812,489,103		1,270,066,220		1,059,235,420		0		88,397,919	
Diversified Industries	226,728,836,046	27,289,129,636	12%	6,997,700,729	3%	1,285,708,642	1%	63,135,508	0%	751,313,010	0%
Percent of Provincial Total		15%		15%		4%		23%		36%	
Number of Issuers	339	57		40		8		1		3	
Avg. Market Cap/Issuer	668,816,626	478,756,660		174,942,518		160,713,580		63,135,508		250,437,670	
Financial Services	292,411,479,885	5,857,275,157	2%	375,453,499	0%	24,235,439,011	8%	212,587,200	0%	265,000,000	0%
Percent of Provincial Total		3%		1%		80%		77%		13%	
Number of Issuers	243	16		5		9		1		1	
Avg. Market Cap/Issuer	1,203,339,423	366,079,697		75,090,700		2,692,826,557		212,587,200		265,000,000	
Forest Products	16,132,087,784	0	0%	4,170,652,574	26%	741,000,000	5%	0	0%	0	0%
Percent of Provincial Total		0%		9%		2%		0%		0%	
Number of Issuers	26	0		12		1		0		0	
Avg. Market Cap/Issuer	620,464,915	0		347,554,381		741,000,000		0		0	
Life Sciences	23,610,856,034	649,974,535	3%	3,800,694,741	16%	790,694,715	3%	0	0%	0	0%
Percent of Provincial Total		0%		8%		3%		0%		0%	
Number of Issuers	73	5		14		2		0		0	
Avg. Market Cap/Issuer	323,436,384	129,994,907		271,478,196		395,347,358		0		0	
Mining	86,788,899,857	3,311,735,419	4%	14,134,499,089	16%	0	0%	0	0%	0	0%
Percent of Provincial Total		2%		31%		0%		0%		0%	
Number of Issuers	159	5		63		0		0		0	
Avg. Market Cap/Issuer	545,842,137	662,347,084		224,357,128		0		0		0	
Oil & Gas	215,994,742,984	119,689,631,290	55%	1,081,841,708	1%	0	0%	0	0%	0	0%
Percent of Provincial Total		67%		2%		0%		0%		0%	
Number of Issuers	123	113		5		0		0		0	
Avg. Market Cap/Issuer	1,756,054,821	1,059,200,277		216,368,342		0		0		0	
Real Estate	19,529,852,155	1,478,151,264	8%	1,326,068,252	7%	0	0%	0	0%	0	0%
Percent of Provincial Total		1%		3%		0%		0%		0%	
Number of Issuers	41	10		7		0		0		0	
Avg. Market Cap/Issuer	476,337,857	147,815,126		189,438,322		0		0		0	
Technology	47,645,213,483	269,070,389	1%	3,389,016,223	7%	2,093,755	0%	0	0%	0	0%
Percent of Provincial Total		0%		7%		0%		0%		0%	
Number of Issuers	128	10		24		1		0		0	
Avg. Market Cap/Issuer	372,228,230	26,907,039		141,209,009		2,093,755		0		0	
Utilities and Pipelines	37,093,240,328	15,182,154,572	41%	2,333,548,995	6%	0	0%	0	0%	958,756,562	3%
Percent of Provincial Total		9%		5%		0%		0%		46%	
Number of Issuers	23	12		1		0		0		1	
Avg. Market Cap/Issuer	1,612,749,579	1,265,179,548		2,333,548,995		0		0		958,756,562	

Table 1c – Market Capitalization of TSX-Listed Issuers (Continued)

	Northwest Territories	Percentage of Sectoral Total	Nova Scotia	Percentage of Sectoral Total	Ontario	Percentage of Sectoral Total	Quebec	Percentage of Sectoral Total	Saskatchewan	Percentage of Sectoral Total
Total	5,368,501		11,663,584,126		492,615,671,302		155,565,364,310		7,553,397,474	
Communications and Media	0	0%	4,422,615,328	4%	39,483,604,126	39%	39,261,269,099	39%	0	0%
Percent of Provincial Total	0%		38%		8%		25%		0%	
Number of Issuers	0		3		31		18		0	
Avg. Market Cap/Issuer	0		1,474,205,109		1,273,664,649		2,181,181,617		0	
Diversified Industries	5,368,501	0%	3,714,489,192	2%	98,129,228,392	43%	45,090,591,933	20%	825,640,138	0%
Percent of Provincial Total	100%		32%		20%		29%		11%	
Number of Issuers	1		6		155		65		3	
Avg. Market Cap/Issuer	5,368,501		619,081,532		633,091,796		693,701,414		275,213,379	
Financial Services	0	0%	441,599,500	0%	221,328,675,068	76%	36,548,892,481	12%	0	0%
Percent of Provincial Total	0%		4%		45%		23%		0%	
Number of Issuers	0		2		193		16		0	
Avg. Market Cap/Issuer	0		220,799,750		1,146,780,700		2,284,305,780		0	
Forest Products	0	0%	0	0%	1,474,498,435	9%	9,664,093,515	60%	0	0%
Percent of Provincial Total	0%		0%		0%		6%		0%	
Number of Issuers	0		0		4		9		0	
Avg. Market Cap/Issuer	0		0		368,624,609		1,073,788,168		0	
Life Sciences	0	0%	0	0%	15,531,840,728	66%	2,795,513,145	12%	0	0%
Percent of Provincial Total	0%		0%		3%		2%		0%	
Number of Issuers	0		0		27		25		0	
Avg. Market Cap/Issuer	0		0		575,253,360		111,820,526		0	
Mining	0	0%	125,745,595	0%	42,734,220,018	49%	14,216,044,246	16%	6,682,394,870	8%
Percent of Provincial Total	0%		1%		9%		9%		88%	
Number of Issuers	0		2		68		18		3	
Avg. Market Cap/Issuer	0		62,872,798		628,444,412		789,780,236		2,227,464,957	
Oil & Gas	0	0%	0	0%	18,138,115,083	8%	121,232,768	0%	45,362,466	0%
Percent of Provincial Total	0%		0%		4%		0%		1%	
Number of Issuers	0		0		3		1		1	
Avg. Market Cap/Issuer	0		0		6,046,038,361		121,232,768		45,362,466	
Real Estate	0	0%	850,751,286	4%	15,347,507,736	79%	527,373,615	3%	0	0%
Percent of Provincial Total	0%		7%		3%		0%		0%	
Number of Issuers	0		3		19		2		0	
Avg. Market Cap/Issuer	0		283,583,762		807,763,565		263,686,808		0	
Technology	0	0%	0	0%	39,401,793,332	83%	4,093,843,825	9%	0	0%
Percent of Provincial Total	0%		0%		8%		3%		0%	
Number of Issuers	0		0		74		19		0	
Avg. Market Cap/Issuer	0		0		532,456,667		215,465,464		0	
Utilities and Pipelines	0	0%	2,076,123,294	6%	1,046,188,384	3%	3,246,509,684	9%	0	0%
Percent of Provincial Total	0%		18%		0%		2%		0%	
Number of Issuers	0		2		3		4		0	
Avg. Market Cap/Issuer	0		1,038,061,647		348,729,461		811,627,421		0	

Table 1d – Market Capitalization of TSX Venture Exchange-Listed Issuers

	Total	Alberta	Percentage of Sectoral Total	British Columbia	Percentage of Sectoral Total	Manitoba	Percentage of Sectoral Total	New Brunswick	Percentage of Sectoral Total	Newfoundland	Percentage of Sectoral Total
Total	**$11,798,298,645**	3,229,480,214		4,854,155,926		92,447,303		33,631,209		67,800,327	
Communications and Media	252,278,586	178,540,653	71%	37,421,916	15%	0	0%	0	0%	0	0%
Percent of Provincial Total	2%	6%		1%		0%		0%		0%	
Number of Issuers	29	5		14		0		0		0	
Avg. Market Cap/Issuer	8,699,262	35,708,131		2,672,994		0		0		0	
Diversified Industries	1,830,109,249	335,352,890	18%	662,249,433	36%	6,567,093	0%	1,745,268	0%	14,026,750	1%
Percent of Provincial Total	16%	10%		14%		7%		5%		21%	
Number of Issuers	335	81		111		3		3		1	
Avg. Market Cap/Issuer	5,463,013	4,140,159		5,966,211		2,189,031		581,756		14,026,750	
Financial Services	464,558,595	62,458,428	13%	68,382,674	15%	12,175,845	3%	0	0%	0	0%
Percent of Provincial Total	4%	2%		1%		13%		0%		0%	
Number of Issuers	81	17		25		2		0		0	
Avg. Market Cap/Issuer	5,735,291	3,674,025		2,735,307		6,087,923		0		0	
Forest Products	320,353	0	0%	320,353	100%	0	0%	0	0%	0	0%
Percent of Provincial Total	0%	0%		0%		0%		0%		0%	
Number of Issuers	1	0		1		0		0		0	
Avg. Market Cap/Issuer	320,353	0		320,353		0		0		0	
Life Sciences	0	0	0%	0	0%	0	0%	0	0%	0	0%
Percent of Provincial Total	0%	0%		0%		0%		0%		0%	
Number of Issuers	0	0		0		0		0		0	
Avg. Market Cap/Issuer	0	0		0		0		0		0	
Mining	5,264,639,235	422,791,808	8%	3,156,569,789	60%	24,317,630	0%	4,924,913	0%	49,924,691	1%
Percent of Provincial Total	0%	13%		65%		0%		0%		0%	
Number of Issuers	918	77		584		6		1		7	
Avg. Market Cap/Issuer	5,734,901	5,490,803		5,405,085		4,052,938		4,924,913		7,132,099	
Oil & Gas	2,400,768,362	1,859,817,604	77%	288,669,785	12%	2,621,001	0%	0	0%	3,848,886	0%
Percent of Provincial Total	0%	58%		6%		0%		0%		0%	
Number of Issuers	282	173		89		1		0		1	
Avg. Market Cap/Issuer	8,513,363	10,750,391		3,243,481		2,621,001		0		3,848,886	
Real Estate	298,616,167	64,870,708	22%	56,050,788	19%	4,732,400	2%	26,961,028	9%	0	0%
Percent of Provincial Total	0%	2%		1%		0%		0%		0%	
Number of Issuers	61	22		16		2		1		0	
Avg. Market Cap/Issuer	4,895,347	2,948,669		3,503,174		2,366,200		26,961,028		0	
Technology	1,571,555,021	244,047,869	16%	508,140,372	32%	9,912,211	1%	0	0%	0	0%
Percent of Provincial Total	0%	8%		10%		11%		0%		0%	
Number of Issuers	324	61		139		4		1		0	
Avg. Market Cap/Issuer	4,850,478	4,000,785		3,655,686		9,912,211		0		0	
Utilities and Pipelines	476,762,570	45,401,504	10%	22,807,978	5%	31,351,122	7%	0	0%	0	0%
Percent of Provincial Total	0%	1%		0%		34%		0%		0%	
Number of Issuers	10	3		4		2		0		0	
Avg. Market Cap/Issuer	47,676,257	15,133,835		22,807,978		15,675,561		0		0	

Table 1d – Market Capitalization of TSX Venture Exchange-Listed Issuers (Continued)

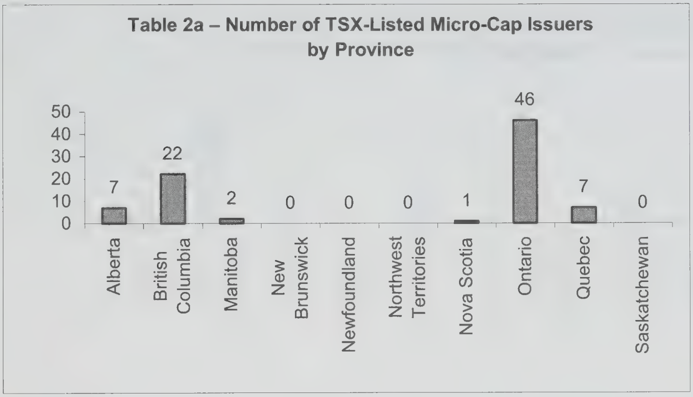
Total	Northwest Territories 2,983,500	Percentage of Sectoral Total	Nova Scotia 88,391,747	Percentage of Sectoral Total	Ontario 2,491,408,980	Percentage of Sectoral Total	Quebec 860,049,935	Percentage of Sectoral Total	Saskatchewan 77,949,504	Percentage of Sectoral Total
Communications and Media	0	0%	0	0%	32,458,346	13%	3,857,670	2%	0	0%
Percent of Provincial Total	0%		0%		1%		0%		0%	
Number of Issuers	0		0		9		1		0	
Avg. Market Cap/Issuer	0		0		3,606,483		3,857,670		0	
Diversified Industries	2,983,500	0%	0	0%	452,035,980	25%	245,833,939	13%	9,314,449	1%
Percent of Provincial Total	100%		0%		18%		29%		12%	
Number of Issuers	1		0		101		31		3	
Avg. Market Cap/Issuer	2,983,500		0		4,475,604		7,930,127		3,104,816	
Financial Services	0	0%	240,000	0%	283,592,355	61%	5,914,038	1%	0	0%
Percent of Provincial Total	0%		0%		11%		1%		0%	
Number of Issuers	0		1		32		4		0	
Avg. Market Cap/Issuer	0		240,000		8,862,261		1,478,510		0	
Forest Products	0	0%	0	0%	0	0%	0	0%	0	0%
Percent of Provincial Total	0%		0%		0%		0%		0%	
Number of Issuers	0		0		0		0		0	
Avg. Market Cap/Issuer	0		0		0		0		0	
Life Sciences	0	0%	0	0%	0	0%	0	0%	0	0%
Percent of Provincial Total	0%		0%		0%		0%		0%	
Number of Issuers	0		0		0		0		0	
Avg. Market Cap/Issuer	0		0		0		0		0	
Mining	0	0%	14,584,915	0%	1,081,717,876	21%	363,793,913	7%	47,263,288	1%
Percent of Provincial Total	0%		17%		43%		42%		61%	
Number of Issuers	0		5		168		66		4	
Avg. Market Cap/Issuer	0		2,916,983		6,438,797		5,512,029		11,815,822	
Oil & Gas	0	0%	22,493,090	1%	48,113,716	2%	36,949,297	2%	537,047	0%
Percent of Provincial Total	0%		25%		2%		4%		1%	
Number of Issuers	0		4		12		1		1	
Avg. Market Cap/Issuer	0		5,623,272		4,009,476		36,949,297		537,047	
Real Estate	0	0%	9,628,999	3%	97,807,176	33%	38,431,939	13%	133,127	0%
Percent of Provincial Total	0%		11%		4%		4%		0%	
Number of Issuers	0		2		13		4		1	
Avg. Market Cap/Issuer	0		4,814,500		7,523,629		9,607,985		133,127	
Technology	0	0%	41,444,742	3%	472,371,661	30%	153,971,407	10%	19,551,593	1%
Percent of Provincial Total	0%		0%		19%		18%		0%	
Number of Issuers	0		4		78		34		2	
Avg. Market Cap/Issuer	0		10,361,186		6,056,047		4,528,571		9,775,796	
Utilities and Pipelines	0	0%	0	0%	7,986,004	2%	2,512,274	1%	0	0%
Percent of Provincial Total	0%		0%		0%		0%		0%	
Number of Issuers	0		0		2		1		0	
Avg. Market Cap/Issuer	0		0		3,993,002		2,512,274		0	

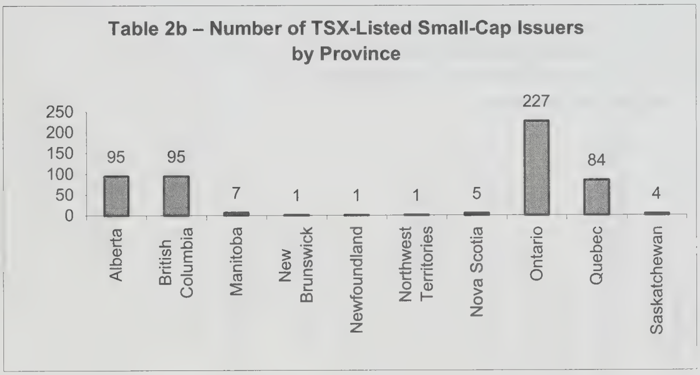
Table 1e – Combined Market Capitalization of TSX- and TSX-Venture Exchange Listed Issuers

	Total	Alberta	Percentage of Sectoral Total	British Columbia	Percentage of Sectoral Total	Manitoba	Percentage of Sectoral Total	New Brunswick	Percentage of Sectoral Total
Total	**$934,792,957,847**	181,019,047,989		50,084,029,059		30,325,089,686		309,353,917	
Communications and Media	100,802,490,051	4,240,986,168	4%	7,657,819,238	8%	3,177,706,260	3%	0	0%
Percent of Provincial Total		2%		15%		10%		0%	
Number of Issuers	96	10		20		3		0	
Diversified Industries	228,558,945,295	27,624,482,526	12%	7,659,950,162	3%	1,292,275,735	1%	64,880,777	0%
Percent of Provincial Total		15%		15%		4%		21%	
Number of Issuers	674	138		151		11		4	
Financial Services	292,876,038,480	5,919,733,584	2%	443,836,173	0%	24,247,614,857	8%	212,587,200	0%
Percent of Provincial Total		3%		1%		80%		69%	
Number of Issuers	324	33		30		11		1	
Forest Products	16,132,408,137	0	0%	4,170,972,927	26%	741,000,000	5%	0	0%
Percent of Provincial Total		0%		8%		2%		0%	
Number of Issuers	27	0		13		1		0	
Life Sciences	23,610,856,034	649,974,535	3%	3,800,694,741	16%	790,694,715	3%	0	0%
Percent of Provincial Total		0%		8%		3%		0%	
Number of Issuers	73	5		14		2		0	
Mining	92,053,539,092	3,734,527,227	4%	17,291,068,878	19%	24,317,630	0%	4,924,913	0%
Percent of Provincial Total		2%		35%		0%		2%	
Number of Issuers	1077	82		647		6		1	
Oil & Gas	218,395,511,346	121,549,448,894	56%	1,370,511,492	1%	2,621,001	0%	0	0%
Percent of Provincial Total		67%		3%		0%		0%	
Number of Issuers	405	286		94		1		0	
Real Estate	19,828,468,322	1,543,021,972	8%	1,382,119,041	7%	4,732,400	0%	26,961,028	0%
Percent of Provincial Total		1%		3%		0%		9%	
Number of Issuers	102	32		23		2		1	
Technology	49,216,768,504	513,118,257	1%	3,897,156,595	8%	12,005,966	0%	0	0%
Percent of Provincial Total		0%		8%		0%		0%	
Number of Issuers	452	71		163		5		0	
Utilities and Pipelines	37,570,002,898	15,227,556,076	41%	2,356,356,973	6%	31,351,122	0%	0	0%
Percent of Provincial Total		8%		5%		0%		0%	
Number of Issuers	33	15		5		2		0	

Table 1e – Combined Market Capitalization of TSX- and TSX-Venture Exchange Listed Issuers (Continued)

	Newfoundland	Percentage of Sectoral Total	Northwest Territories	Percentage of Sectoral Total	Nova Scotia	Percentage of Sectoral Total	Ontario	Percentage of Sectoral Total	Quebec	Percentage of Sectoral Total	Saskatchewan	Percentage of Sectoral Total
Total	2,131,267,817		8,352,001		11,751,975,873		495,107,080,282		156,425,414,245		7,631,346,978	
Communications and Media	88,397,919	0%	0	0%	4,422,615,328	4%	39,516,062,472	39%	39,265,126,769	39%	0	0%
Percent of Provincial Total	4%		0%		38%		8%		25%		0%	
Number of Issuers	1		0		3		40		19		0	
Diversified Industries	765,339,760	0%	8,352,001	0%	3,714,489,192	2%	98,581,264,373	43%	45,336,425,873	20%	834,954,586	0%
Percent of Provincial Total	36%		100%		32%		20%		29%		11%	
Number of Issuers	4		2		6		256		96		6	
Financial Services	265,000,000	0%	0	0%	441,839,500	0%	221,612,267,423	76%	36,554,806,519	12%	0	0%
Percent of Provincial Total	12%		0%		4%		45%		23%		0%	
Number of Issuers	1		0		3		225		20		0	
Forest Products	0	0%	0	0%	0	0%	1,474,498,435	9%	9,664,093,515	60%	0	0%
Percent of Provincial Total	0%		0%		0%		0%		6%		0%	
Number of Issuers	0		0		0		4		9		0	
Life Sciences	0	0%	0	0%	0	0%	15,531,840,728	66%	2,795,513,145	12%	0	0%
Percent of Provincial Total	0%		0%		0%		3%		2%		0%	
Number of Issuers	0		0		0		27		25		0	
Mining	49,924,691	0%	0	0%	140,330,511	0%	43,815,937,895	48%	14,579,838,159	16%	6,729,658,159	7%
Percent of Provincial Total	2%		0%		1%		9%		9%		88%	
Number of Issuers	7		0		7		236		84		7	
Oil & Gas	3,848,886	0%	0	0%	22,493,090	0%	18,186,228,799	8%	158,182,065	0%	45,899,514	0%
Percent of Provincial Total	0%		0%		0%		4%		0%		1%	
Number of Issuers	1		0		4		15		2		2	
Real Estate	0	0%	0	0%	860,380,286	4%	15,445,314,912	78%	565,805,555	3%	133,127	0%
Percent of Provincial Total	0%		0%		7%		3%		0%		0%	
Number of Issuers	0		0		5		32		6		1	
Technology	0	0%	0	0%	41,444,742	0%	39,874,164,993	81%	4,247,815,231	9%	19,551,593	0%
Percent of Provincial Total	0%		0%		0%		8%		3%		0%	
Number of Issuers	0		0		4		152		53		2	
Utilities and Pipelines	958,756,562	0%	0	0%	2,076,123,294	6%	1,054,174,387	3%	3,249,021,958	9%	0	0%
Percent of Provincial Total	45%		0%		18%		0%		2%		0%	
Number of Issuers	1		0		2		5		5		0	





Source: Raw Data from Toronto Stock Exchange (at May 31, 2003)

Table 3a – Number of TSX Venture Exchange-Listed Micro Cap Issuers by Province

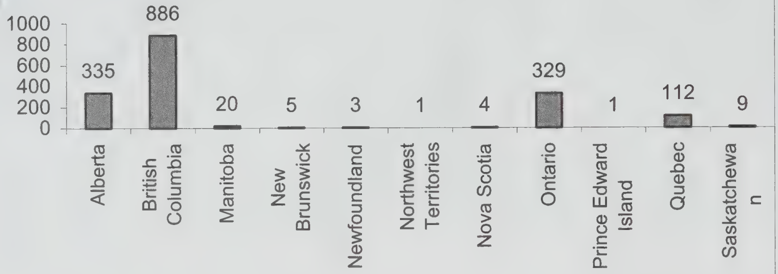
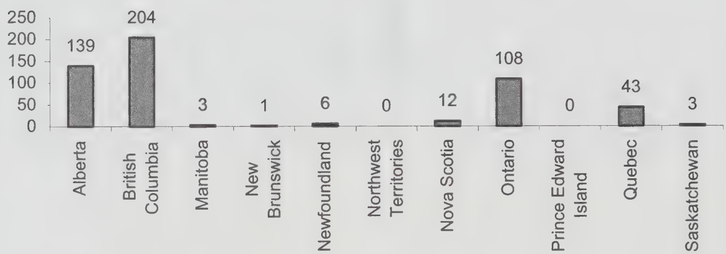


Table 3b – Number of TSX Venture Exchange-Listed Small Cap Issuers by Province



Source: Raw Data from TSX Venture Exchange (at July 7, 2003)

Table 4a – Number of TSX- and TSX Venture Exchange-Listed Micro Cap Issuers by Province

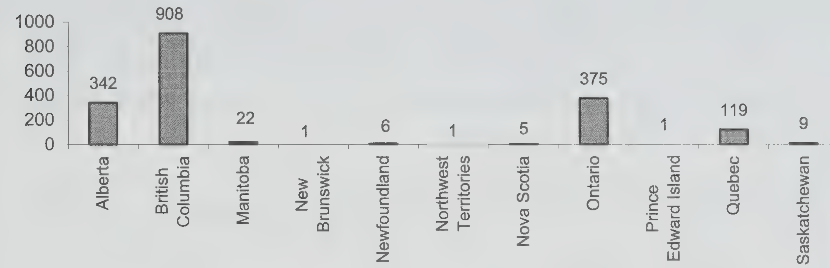
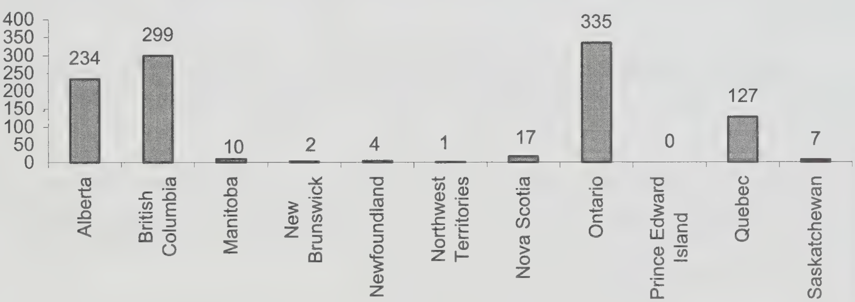


Table 4b – Number of TSX- and TSX Venture Exchange-Listed Small Cap Issuers by Province



Source: Raw Data from Toronto Stock Exchange (at May 31, 2003) and TSX Venture Exchange (at July 7, 2003)

Appendix C – History of the Merger of Stock Exchanges in Canada

Prior to 1999, there were five stock exchanges in Canada. The four major exchanges included the Vancouver Stock Exchange (VSE), Alberta Stock Exchange (ASE), Toronto Stock Exchange (TSE, now known as TSX) and Montreal Exchange (ME). Canada's smallest exchange was the Winnipeg Stock Exchange (WSE). In addition, the TSE operated an over-the-counter trading system known as the Canadian Dealing Network (CDN). It was the exchange's market for small equity trading.

In 1999, Canada's stock exchanges went through a major restructuring. The purpose was to create a globally competitive trading market through market specialization, increased liquidity, and operating cost savings. To achieve this goal, the four major exchanges entered into an agreement to restructure the Canadian trading markets. As a result of this agreement, the ASE, VSE and "parts" of the ME and TSE (specifically, the CDN) merged into a new market called the Canadian Venture Exchange (CDNX). CDNX became Canada's junior equities exchange and was centralized in Western Canada (with a head office in Calgary and another office in Vancouver). The TSE became the sole senior equities exchange in Canada.[181] The ME became the exchange for derivatives trading.[182]An invitation was extended to the WSE to participate in the new junior market.

In 2000, several developments occurred in respect of the restructuring of the Canadian capital markets: the WSE merged with CDNX and became a regional office, and CDNX opened an office in Toronto.

By 2001, the TSE purchased CDNX and began operating it as a subsidiary that continued to service the junior venture capital market. This development brought all of Canada's equity trading under one roof.[183] CDNX's head office remained in Calgary, and operational branches were located in Vancouver, Toronto, Winnipeg and Montreal.

In 2002, the Toronto Stock Exchange Inc. changed the logo of the exchange from "TSE" to "TSX". As well, the CDNX became the TSX Venture Exchange and continues to trade junior equities.

Currently, the TSX Group of companies – TSX, TSX Venture Exchange and TSX Markets (formerly TSE-CDNX Markets Inc.) – collectively manages Canada's senior and junior equity markets. The TSX group of companies is headquartered in Toronto and maintains division offices in Montreal, Winnipeg, Calgary and Vancouver.[184]

In the TSX Group's submission to the Wise Persons' Committee, it states that it plans to expand the TSX Venture Exchange into the Atlantic provinces. It states: "The interest among all regulators in TSX Venture Exchange will almost certainly increase as we increase the national

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181 The TSX transferred its junior equity trading to CDNX and its derivatives trading to the MSE.
182 The MSE transferred its junior equity trading to CDNX and its senior equities trading to the TSE.
183 See TSX Media Release, online at http://www.tse.com/en/pdf/TSXGroupOverview.pdf.
184 See TSX website, online at http://www.tsx.ca/en/aboutus/index.html.

character of the exchange which, you will recall, was created out of the merger of five small, predominantly local and, for the most part, western Canadian stock exchanges. Since acquiring the consolidated exchanges – Canadian Venture Exchange (CDNX) – in 2001, we have expanded its operations in Ontario and Quebec. We see further expansion ahead, both in Central Canada and in the Atlantic Provinces, both areas that were long under-served in terms of the public venture market."[185]

[185] TSX Group Inc., submission to WPC.

Appendix D – SEC Locations: Headquarter, Regional and District Offices[186]

Name of Office	Location	Region Covered
Headquarters (includes Office of Investor Education & Assistance)	Washington, DC	
1. Northeast Regional Office	New York, NY	Connecticut, Delaware, District of Columbia, Maine, Maryland, Massachusetts, New Hampshire, New Jersey, New York, Pennsylvania, Rhode Island, Vermont, Virginia and West Virginia
2. Pacific Regional Office	Los Angeles, CA	Alaska, Arizona, California, Guam, Hawaii, Idaho, Montana, Nevada, Oregon and Washington
3. Southeast Regional Office	Miami, FL	Alabama, Florida, Georgia, Louisiana, Mississippi, North Carolina, Puerto Rico, South Carolina, Tennessee and Virgin Islands
4. Midwest Regional Office	Chicago, IL	Illinois, Indiana, Iowa, Kentucky, Nebraska, New Mexico, North Dakota, Oklahoma, South Dakota, Texas, Utah and Wyoming
5. Atlanta District Office	Atlanta, GA	
6. Forth Worth District Office	Fort Worth, TX	
7. Salt Lake District Office	Salt Lake City, UT	
8. San Francisco District Office	San Francisco, CA	
9. Boston District Office	Boston, MA	
10. Philadelphia District Office	Philadelphia, PA	

186 *SEC Addresses: Headquarters, Regional, and District Offices*, online at http://www.sec.gov/contact/addresses.htm.

Provincial Preferences in Private Equity

Research Study Prepared for the
Wise Persons' Committee

Douglas Cumming
Aditya Kaul
Vikas Mehrotra

September 8, 2003

Provincial Preferences in Private Equity

Biographies

Douglas Cumming

Douglas Cumming, B.Com. (Hons.), M.A., J.D., Ph.D., CFA, is currently an Assistant Professor of Finance, Economics and Law at the University of Alberta School of Business, and has recently accepted the position of Associate Professor of Finance at the University of New South Wales School of Banking and Finance. He has also held / will hold the following visiting professorships: ABN AMRO Bank Visiting Professor of Finance at the University of Amsterdam Graduate School of Business (2002, 2003),Center for Financial Studies, University of Frankfurt Visiting Scholar (2004), and University of Cambridge Judge Institute of Management Visiting Scholar (2004). Dr. Cumming's research is primarily focused on private equity and venture capital, with a focus on international differences in private equity and venture capital markets, including the European, North American and Asia-Pacific private equity and venture capital markets.

Aditya Kaul

Aditya Kaul is currently an Associate Professor of Finance at the University of Alberta. He joined the business faculty in 1996 with a PhD in Finance from the University of Rochester. His research interests are in the areas of market microstructure, international finance and asset pricing. Dr. Kaul's work has been published in the *Journal of Finance* and the *Journal of Financial Economics*, and has been presented at major academic conferences in North America. He is the recipient of several research awards including the 1999 Toronto Society of Financial Analysts award for his study on the effects of changes in the definition of the public float on the Toronto Stock Exchange, and a 2000 Q-Group award for his study of common effects in trading activity, prices and trading costs. He has consulted for government organizations and private firms in Canada and the United States and held a visiting position at the University of Oregon in 2000-2001.

Vikas Mehrotra

Dr. Vikas Mehrotra has been a faculty member at the University of Alberta since 1992, after graduating from the University of Oregon with a doctorate in Finance. He currently holds the position of Associate Dean, MBA Programs, as well as the Collins chair in Finance, at the School of Business there. From July-2001 through June-2002, Dr. Mehrotra was a visiting professor of Finance at the prestigious Kenan-Flagler Business School at the University of North Carolina. Dr. Mehrotra's work deals with corporate restructuring, capital structure, and financial markets. His studies have been published in leading finance journals such as the *Journal of Finance*, the *Journal of Financial Economics*, and the *Review of Financial Studies*.

Provincial Preferences in Private Equity

Executive Summary

We study the frequency with which private equity investors and entrepreneurs are located in different provinces. We present descriptive statistics that show the existence of a strong provincial preference for domestic investing. For all types of investors and entrepreneurial firms, in terms of the numbers of investments (13,729 transactions), 84.42% of investments involved an investor and entrepreneur that resided in the same province. In terms of the total value of these transactions ($20,193,896,909 in 1997 dollars), 61.15% of the investment value was intra-provincial. This is an expected result, as it is easier for an investor to provide value-added advice to investees that are geographically proximate. The data are therefore consistent with the view that Canadian venture capitalists and other private equity investors provide value-added advice to investees, and the venture capital market is very important for Canadian entrepreneurship and economic growth.

The data used in this study are from Macdonald & Associates Limited. Macdonald & Associates has built the most comprehensive database on venture capital and private equity in Canada. Transactions are from numerous different types of investors: corporate, institutional, government, private (typically limited partnerships), labour-sponsored venture capital corporations (LSVCCs), and “other” types of investors with an interest in specific private equity deals, but without a permanent market presence. The types of investee firms in the database are also broad in scope: various stages of development (start-up, expansion, buyout, turnaround) industries (life-sciences, other high tech, and traditional non-high tech), and whether the investee firm is privately held or publicly traded on a stock exchange. A wide variety of securities (common equity, preferred equity, convertible preferred equity, debt, convertible debt, warrants, mixes of debt and common equity, mixes of preferred equity and common equity, and other combinations) and deal types (staging, syndication, and amounts invested ranging from less than $10,000 to more than $100,000,000) appear in the data.

We show differences in the likelihood of intra- versus inter-provincial investing depends on most of these firm- and transaction-specific characteristics. We also document differences in the likelihood of intra- versus inter-provincial investing over time, as well as differences depending on the province. Inter-provincial investing (in which the entrepreneur and investor are not in the same province) is more likely when the investee firm is publicly traded, in 1999-2003 relative to 1991-1998, in syndicated investments, in preferred equity and convertible preferred equity investments, and in investments where the entrepreneur is resident in British Columbia, Alberta, Saskatchewan, Newfoundland, New Brunswick, Nova Scotia, or Prince Edward Island (while the frequency of inter-provincial investments in Manitoba is similar to the national average). Intra-provincial investing (in which the entrepreneur and investor are in the same province) is more likely for turnaround stage firms, firms in traditional industries (as opposed to life science and other types of high tech firms), government and labour-sponsored investors, first-round investments as opposed to follow-on investments, smaller deal sizes, debt investments, and for entrepreneurs resident in Ontario and Quebec.

We interpret the results from the perspective of the benefits and drawbacks for federal versus provincial securities regulation, with reference to available comparative evidence from U.S. studies. On one hand, one may interpret the evidence in favor of regional securities regulators and regulations. A significant majority of investments (that is, private equity investments) are carried out by investors and investees resident in the same province, and therefore local regulations can be tailored to meet the needs of the local market. In the U.S., for example, despite the federal Securities and Exchange Commission, there is a continuing state role in regulating intra-state and exempt offerings. On the other hand, one may interpret the evidence in favor of a national regulator. "Home-bias" is present in U.S. venture capital markets, as well as among U.S. mutual funds. Generally, it is well documented that there is a strong informational advantage to investing in geographically proximate companies, and both venture capitalists and mutual funds in the U.S. tend to earn higher returns when a greater proportion of their portfolio of investees was geographically proximate. The existence of home bias is not a sufficient condition to conclude that securities markets should be regulated differently in different regions and/or that the identity of the regulator should be different for different regions. For example, the U.S. does exhibit a significant degree of home bias in private equity markets, but the U.S. also has a uniform securities act and a single federal regulatory body (albeit, there is a continuing state role in regulating intra-state and exempt offerings). Differences in regulations across provinces may in fact exacerbate the degree of home bias: one interpretation of the different regression results across Tables 4-7 is that different province-specific regulations give rise to differences in the likelihood of inter- versus intra-provincial investment in different provinces. In this paper we simply point to two different ways of interpreting the data from the perspective of provincial versus federal securities regulation, without advancing an opinion as to which view is "more correct" or "better informed".

Finally, we point out certain limitations in the data for the purpose of addressing the degree of regional segmentation in Canadian markets generally. First, the coverage of the data is obviously not 100% of all transactions in Canada. For example, specific industries like mining and oil and gas are not covered in the database. In consultations with the Alberta and British Columbia Securities Commissions, we were informed that a much greater degree of "home bias" exists for those industries: mining firms in British Columbia and oil and gas firms in Alberta. Second, we stress that the data are focused on private equity and do not comprise investments from mutual funds and certain other institutions. We would expect less home bias for mutual funds and other investors of publicly traded companies. Third, the data cover investments and not sales of investments through initial public offerings (IPOs) and acquisitions, etc. Macdonald & Associates Limited believe (based on anecdotal evidence) that sale transactions more often involve sales to new investors resident in different provinces, or foreign investors. Nevertheless, despite these limitations, the breadth of transactions in terms of the heterogeneity of investors, entrepreneurs and types of transactions does enable us to extrapolate certain generalizations beyond the realm of the private equity market. For example, our evidence herein that larger transactions are more often inter-provincial is consistent with the anecdotal evidence that sale transactions are more often inter-provincial or involve foreign investors. For the most part, however, the results in the paper should be considered to apply to the context of Canadian private equity investments only.

Provincial Preferences in Private Equity[1]

1. Introduction

This paper identifies a strong tendency for Canadian private equity investors to finance entrepreneurs that reside in the same province (hereafter referred to as "intra-provincial investments"). For all types of investors and entrepreneurial firms, in terms of the numbers of investments (13,729 transactions), 84.42% of investments involved an investor and entrepreneur that resided in the same province. In terms of the total value of these transactions ($20,193,896,909 in 1997 dollars), 61.15% of the investment value was intra-provincial. We also find differences in the frequency of transactions in which entrepreneurs and investors reside in different provinces (hereafter referred to as "inter-provincial investments"), and provide evidence that certain economic and institutional factors systematically give rise to differences in the frequency of inter- versus intra-provincial investments.

The "home preference" or "provincial preference" for private equity investments is an expected result. Private equity investors, particularly venture capital funds, are widely regarded as active value-added investors that spend a significant amount of time serving on entrepreneurial firm board of directors, providing strategic, financial, marketing and administrative advice.[2] Investors even frequently retain strong veto and control rights, including the contractual right to replace the founding entrepreneur as CEO of the company. It is therefore natural to expect private equity investors to invest in geographically proximate entrepreneurial firms.

Geographic proximity in venture capitalist investing has been documented in the U.S. Professor Lerner shows VCs that are geographically closer to their entrepreneurial investee firms are more likely to serve on the firm's board of directors.[3] Similarly, Professors Sorenson and Stuart show the likelihood of a venture capitalist investing in an entrepreneurial firm increases the greater the degree of proximity between the investor and entrepreneur.[4] In short, the "home bias" preference is found in U.S. venture capitalist financings of privately held companies. As well, home bias in private equity is consistent with recent evidence from U.S. mutual fund investments which show a geographically proximate preference for investments in publicly

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[1] We owe a very special thanks to Macdonald & Associates Limited for generously providing the data. Mary Macdonald, Dmitri Safine, Kathy Jeramaz-Larson and Kirk Falconer were especially helpful, and provided many useful suggestions. We are also particularly indebted to Doug Harris for a number of helpful comments.

[2] See, e.g., Barry *et al.* (1990); Gompers (1995, 1996, 1998); Gompers and Lerner (1999, 2000, 2001); Gorman and Sahlman (1989); Kanniainen and Keuschnigg (2000, 2001); Lerner (1994, 1995); Sapienza, (1992); Sapienza *et al.* (1996).

[3] Lerner (1995); Gompers and Lerner (1999).

[4] The Sorenson and Stuart (2001) study is based on an artificially constructed dependent variable of feasible investments for the venture fund. We adopt a different approach without the use of artificially generated variables in this paper, and address a different set of issues.

traded companies.[5] Further evidence shows that a geographically proximate investment strategy (within a 100 kilometer radius) increases the average annual mutual fund returns by 2.67%.[6]

This paper contributes to the literature on home bias by exploring the factors that give rise to inter- versus intra-provincial investment activity, and extends the literature in three primary ways. First, we provide a first study of home bias in a non-U.S. dataset – Canada – which offers an analysis of unique institutional market features. For example, we compare home-province preferences for Quebec (a French-speaking civil law province) and other provinces (English speaking common law provinces), and find significant differences in the factors that give rise to intra- versus inter-provincial investment. As well, the Canadian venture capital market is relatively young, and we observe differences over time as the market has matured over the 1991-2003 (1st quarter) period.

Second, we study a more diverse group of entrepreneurial firms than those financed by pure venture capitalists. Venture capitalists in the U.S. invest in entrepreneurial start-ups, and typically high tech firms. In our sample, we consider the broader class of all types of private equity investment, including start-ups as well as expansion stage, buyout and turnaround investments, as well as investments in a diverse array of industries. Some of the investees in our sample also include publicly traded companies. In the datasets considered in prior U.S. research, the venture capital funds are typically restricted from investing in buyout, turnaround, and publicly listed companies.[7] The broader array of entrepreneurial firms considered in our dataset enables a first consideration of geography and private equity investments generally.

Third, we consider different types of investors, including private independent (limited partnership) and corporate investors (as in U.S. studies of geography), as well as institutional, government, and labour-sponsored venture capital funds. Our analysis of geography and investor type enables insights into the investment strategies and constraints across different types of institutions. To our knowledge, geography and investment across a diverse array of different types of investors has not been the subject of empirical study in any market in any country.

The data used in this study are from Macdonald & Associates Limited. Macdonald & Associates has built the most comprehensive database on venture capital and private equity activity in Canada. We consider 13,729 investments over the period 1991 (1st quarter) – 2003 (1st quarter). Transactions are from numerous different types of investors: corporate, institutional, government, private (typically limited partnerships), labour-sponsored venture capital corporations (LSVCCs), and "other" types (investors with an interest in specific private equity deals, but without a permanent market presence). The types of investee firms in the database are also broad in scope: various stages of development (start-up, expansion, buyout, turnaround and "other" not specifically identified), industries (life-sciences, other high tech, and traditional non-high tech), and whether the investee firm is privately held or publicly traded on a stock exchange. A wide variety of securities appear in the data (common equity, preferred equity, convertible preferred equity, debt, convertible debt, warrants, mixes of debt and common

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5 Coval and Moskowitz (2003b).

6 Coval and Moskowitz (2003a).

7 Gompers and Lerner (1996).

equity, mixes of preferred equity and common equity, and other combinations) and deal types (staging, syndication, and amounts invested ranging from less than $10,000 to more than $100,000,000).

We show differences in the likelihood of intra- versus inter-provincial investing depends on most of these firm- and transaction-specific characteristics. We also document differences in the likelihood of intra- versus inter-provincial investing over time, as well as differences depending on the province. Inter-provincial investing (in which the entrepreneur and investor are not in the same province) is more likely when the investee firm is publicly traded, more likely in 1999-2003 relative to 1991-1998, syndicated investments, preferred equity and convertible preferred equity investments, and entrepreneurs resident in British Columbia, Alberta, Saskatchewan, Newfoundland, New Brunswick, Nova Scotia, and Prince Edward Island (while the frequency of inter-provincial investments in Manitoba is similar to the national average). Intra-provincial investing (in which the entrepreneur and investor are in the same province) is more likely for turnaround stage firms, firms in traditional industries (as opposed to life science and other types of high tech firms), government and labour-sponsored investors, more likely for first-round investments as opposed to follow-on investments, smaller deal sizes, debt investments, and for entrepreneurs resident in Ontario and Quebec.

This paper proceeds as follows. Section 2 briefly describes Canada's venture capital and private equity industry. In section 3 we develop testable hypotheses with the institutional structure and in light of prior research. The data are described in section 4, and univariate comparison tests are carried out on the proportion of inter- versus intra-provincial investments for different characteristics on the investments. Multivariate tests of inter- versus intra-provincial investment are carried out in Section 5. Section 6 specifies limitations with the data and the types of tests that can be carried out. Section 7 discusses the evidence in view of the debate on the appropriate securities regulatory structure in Canada. The last section concludes.

2. The Scope of Venture Capital and Private Equity in Canada

This section provides an overview of Canada's venture capital and private equity industry. Summary statistics are presented. These statistics have been compiled from every published issue of the Canadian Venture Capital Association (CVCA) Annual Reports (1978-2003 for the years 1977-2002).[8] Not all of the same statistics were reported each year; the figures presented in this section make use of all of the available data.

Canada's venture capital and private equity funds managed in total approximately $22.5 billion in capital in 2002 (or approximately $20 billion in 1997 dollars).[9] The growth of Canada's venture capital and private equity market by type of investor is depicted in Figure 1: corporate, institutional, government, private limited partnerships, labour-sponsored venture capital corporations (LSVCCs), and "other" types of investors with an interest in specific private equity deals, but without a permanent market presence. Each of these types of funds in Canada

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[8] Source: Macdonald and Associates, Ltd. (see www.canadavc.com), for the Canadian Venture Capital Association (CVCA) (see www.cvca.ca).

[9] *Ibid.*

has been described in previous research.[10] Private independent funds tend to be organized as limited partnerships. Corporate venture capital funds are subsidiaries of large corporations. Federal or provincial governments run government funds through employing professional venture capital fund managers.[11] Hybrid funds are "funds which are formed in response to a government incentive or an investment by government alongside private investors, or which have secured more than 50% of their capital from another hybrid fund".[12]

Canada's venture capital market is unique in that most of the provinces (all except Alberta and Newfoundland) have adopted legislation giving rise to labour-sponsored venture capital corporations (LSVCCs). Briefly, LSVCCs are tax-subsidized mutual funds that invest in private equity. Investors in LSVCCs are limited to individuals, unlike private limited partnerships that receive the majority of their capital from institutional investors like pension funds.[13] LSVCCs have accumulated the most capital under management in recent years (see Figure 1), which can be explained by the tax incentives for investors in LSVCCs.[14]

The following mutually exclusive stages of entrepreneurial firm development in venture capital and private equity are as follows:[15]

- *Start-up Stage*: the entrepreneurial firm may be based on a concept without a product or any marketing, or it may have a product being developed, but not yet sold commercially;

- *Expansion Stage*: the entrepreneurial firm requires significant capital for plant expansion, marketing, and to initiate full commercial production and sales;

- *Acquisition/Buyout Stage* (hereafter "*Buyout Stage*"): the operating management of the entrepreneurial firm acquires a product line, a division, or a company;

- *Turnaround Stage*: the entrepreneurial firm that was once profitable but is now earning less than its cost of capital.

Firms in the later stages (buyout and turnaround) have a longer track record and are easier for the investor to conduct a due diligence review. Start-up firms exhibit the greatest information problems for investors at the time of due diligence review before investment.

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10 Macdonald (1992); MacIntosh (1994); Halpern (1997); Amit *et al.* (1998).

11 Examples of government funds include the Crown Investments Corporation of Saskatchewan and Innovatech du Grand Montreal. Pension funds affiliated with government bodies are classified as institutional investors by the Canadian Venture Capital Association (see http://www.cvca.ca/full_members/index.html).

12 Macdonald (1992) at 4 n3. Since 2000, Macdonald and Associates, Ltd have adopted the category "institutional" instead of "hybrid".

13 Osbourne and Sandler (1998) discuss LSVCCs in much greater detail. The CVCA Annual Reports (posted at http://www.cvca.ca/statistical_review/index.html) provide details on the sources of capital by type of institutional investor.

14 Osbourne and Sandler (1998); Cumming and MacIntosh (2003c).

15 Precise definitions are available at http://www.canadavc.com/info.aspx?page=glossary.

The numbers of investment and total amounts invested in Canada at each stage of development are depicted in Figures 2a and 2b, respectively. In 2000 (2001), 2671 (2043) investments valued at approximately $6.6 billion ($3.8 billion) were completed for all stages of venture capital and private equity in 2000. For comparison, in 2000 (2001), the total number of IPOs on Canadian exchanges was 101 (74) for a total value of $6.8 billion ($5.9 billion).[16] Total investment activity in Canada's venture capital and private equity markets amounted to approximately 0.38% of GDP in Canada over the 1998-2001 period, compared to 0.63% in the United States and 0.30% in the European Union.[17]

Canada comprises 10 provinces and 3 northern territories. As the private equity database considered herein does not comprise investors or investees from the northern territories, our attention is on the 10 provinces (from west to east): British Columbia, Alberta, Saskatchewan, Manitoba, Ontario, Quebec, Newfoundland, New Brunswick, Nova Scotia and Prince Edward Island. Quebec is a French speaking civil law province; the other provinces are English speaking and common law. The majority of economic activity in Canada is generated in Ontario, Quebec, British Columbia and Alberta.18 A majority of venture capital and private equity transactions in Canada are carried out in Quebec and Ontario. The geographic distribution of investment by numbers of transactions and the value of transactions is depicted in Figures 3a and 3b (certain smaller provinces are aggregated together in these figures as per the CVCA Annual Reports; however, our disaggregated data and empirical tests in the subsequent sections consider all provinces separately).

The CVCA covers industries traditionally targeted by venture capital and private equity funds. The CVCA covers the following high tech industries: biotechnology, medical/health related, communications, computer related, Internet related, electronics and "other" technology. The CVCA also covers the following traditional industries: consumer related, manufacturing and "miscellaneous".[19] The numbers and dollar amounts of investments by sector are depicted in Figures 4a, 4b and 4c.

In the subsequent sections we explore the aggregated data presented in this section by making use of disaggregated transaction-specific data. Our focus is on understanding intra- versus inter-provincial investment decisions and testing hypotheses developed in section 3.

3. Institutional Structure, Prior Research and Testable Hypotheses

In this section we describe economic barriers (subsection 3(a) and legal and institutional impediments (subsection 3(b)) to inter-provincial investment. In subsection 3(c) we summarize the factors that are conjectured to affect the frequency of inter-provincial investment in the form of testable hypotheses. Those hypotheses are tested in section 4 with a new dataset described in section 4.

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[16] Source: PriceWaterhouseCoopers http://www.pwc.com/extweb/ncsurvres.nsf/DocID/FE3FEFD25A793A8485256B9D00527270.

[17] Source: OECD http://r0.unctad.org/en/subsites/dite/pdfs/Frank_Lee.pdf.

[18] Source: http://www.innovationstrategy.gc.ca/cmb/innovation.nsf/ProvincialProfiles/.

[19] See http://www.cvca.ca/statistical_review/table_3x2002.html.

(a) *Economic Impediments to Inter-Provincial Investment*

Venture capital and private equity investors invest in companies that are geographically proximate for at least three reasons.[20] First, it is easier to conduct due diligence and screening of companies that are geographically proximate. Venture investors typically receive more than 1000 business plans per year, but seriously consider fewer than 50 companies, and carry out fewer than 10 investments.[21] Venture capital portfolios are small.[22] Second, geographic proximity facilitates information flow and monitoring, as well as the ability to serve effectively on a board of directors and provide value-added advice (strategic, marketing, administrative and financial). Third, while data are unavailable to date, one may postulate[23] that exiting the investment is easier to facilitate and therefore the investment is more profitable when the investor and entrepreneur are geographically proximate. In net, regardless of institutional impediments (discussed below in subsection 3(b)), we expect to find a small number of inter-provincial investments relative to intra-provincial investments.

(b) *Institutional Impediments to Inter-Provincial Investment*

There are at least five barriers to inter-provincial private equity investment in Canada: securities regulation, corporate law, tax law, labour-sponsored venture capital corporation legislation, and governmental fund investment objectives. Each is very briefly discussed in turn.

Securities laws and securities commissions in Canada differ in each province. Regulations themselves are similar, but there are notable differences in different provinces. For the purpose of private equity investment, it is most notable that there are differences in the exemptions from the prospectus requirement among the provinces.[24] These differences are relevant for the smaller ranges of investment of less than approximately $100,000-$150,000 (depending on the province). Inter-provincial differences in securities regulation present certain impediments to inter-provincial investment activity.[25] Most notably, to conduct business in a different province, a lawyer from that province must certify that the transaction was in compliance with the securities laws of that province.

Corporate laws in Canada also differ by province, and there is a federal incorporation option in Canada. Over the 1975-1990 period, the provinces adopted changes to effect similarities in corporate laws, but there are nevertheless differences across provinces. Most companies in Canada are incorporated under either the laws of their home province, or federally.[26] That there are differences in corporate codes also presents a small institutional impediment to investment activities across the different Canadian provinces, as differences

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20 Gompers and Lerner (1999); Sorenson and Stuart (2001).

21 Sahlman (1990).

22 Typically fewer than 30 companies are in a venture portfolio; see Cumming (2001).

23 This is based on mutual fund evidence provided by Coval and Moskowitz (2003a)

24 See, for example, Gillen (1998); see also the various securities commissions' webpages.

25 Harris (2002) discusses numerous pros and cons associated with the current provincial securities regulatory structure in Canada.

26 Daniels (1991); Cumming and MacIntosh (2000, 2002).

in the corporate codes may necessitate different transaction structures, which could increase transaction costs.

Taxation in Canada is paid on the basis of where business is carried out. Differences in tax rates across provinces may discourage inter-provincial investment into provinces with higher tax rates.[27] As well, it is noteworthy in the venture capital context that all of the provinces have R&D tax credit programs (with the exception of Alberta), which reduces the after tax cost of R&D to between $0.45-$0.50 per dollar of R&D expenditures depending on the size of the firm and the particular province (exceptions include Quebec with after tax costs of R&D as low as $0.29 per dollar, and Prince Edward Island with after tax costs of R&D as high as $0.58 per dollar).[28]

Labour-Sponsored Venture Capital Corporations (LSVCCs; described above in section 2) may affect inter-provincial investing activities in two ways. First, LSVCCs are required (by statute) to invest in the province in which they reside. Second, provinces without LSVCCs may have a greater unmet demand for venture finance that is not met by the needs of the local investors.[29] We may therefore conjecture less inter-provincial investment among provinces with LSVCCs, and greater inter-provincial private investment into Alberta and Newfoundland, the two provinces that do not have LSVCCs.

Finally, provincial government funds (described above in section 2) are highly unlikely to invest outside their own province. The funds are directly funded from provincial tax revenues, and it would be politically unwise to invest in companies that reside outside the province's borders.

(c) *Testable Hypotheses: Factors that Affect the Likelihood of Inter-Provincial Investment*

In view of the economic and institutional factors discussed above, we can conjecture that certain factors will be systematically related to the likelihood that an investor and entrepreneur will be located in the same province. These factors are very briefly summarized below and empirical tested in the subsequent sections using the extensive Macdonald & Associates Limited database.

> *Stage of Investee Firm Development*: The earlier the firm's stage of development, the greater the required screening, due diligence and monitoring.[30] We would therefore expect a greater proportion of earlier stage firms to be intra-provincial investments.

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27 Combined federal-provincial corporate income tax rates on large non-manufacturing corporations (excluding special exemptions for subsidized small firms in certain sectors in certain regions) are as follows: British Columbia 35.5%, Alberta 33.5%, Saskatchewan 39%, Manitoba 37%, Ontario 30%, Quebec 31%, New Brunswick 35%, Nova Scotia 38%, Prince Edward Island 38%, and Newfoundland 36% (in the U.S. the 2002 rate is 39%). Source: http://www.innovationstrategy.gc.ca/cmb/innovation.nsf/ProvincialProfiles/.

28 Source: http://www.innovationstrategy.gc.ca/cmb/innovation.nsf/ProvincialProfiles/.

29 This statement assumes that there is a market failure in the provision of private equity among private venture capital funds (i.e., too few private venture capital funds), and that the LSVCCs correct such a market failure. An alternative view is that government funds and/or LSVCCs crowd out private investment. For a more detailed discussion, see Cumming and MacIntosh (2003).

30 Gompers (1995); Gompers and Lerner, (1999).

Investee Capital Requirements: For reasons that are similar to stage of development, we expect smaller investments to be associated with more frequent intra-provincial investment.

Entrepreneurial Firm Industry: High tech firms present greater informational problems for investors, and therefore they require more intensive screening and monitoring,[31] and are more likely to be intra-provincial investments.

Privately Held versus Publicly Traded Investees: Publicly traded companies face a number of reporting requirements, and therefore are much easier to value and monitor than privately held companies. We expect a greater proportion of publicly traded companies to have investors from other provinces than privately held companies.

Type of Investor: As discussed in subsection 3(b), we expect government funds and LSVCCs to more frequently invest in entrepreneurial firms located in the same province. A priori, there is no reason to expect differences between limited partnerships, corporate funds and institutional investors.

Number of Provinces in which the Investor Has Offices: On the one hand, investors with offices in more than 1 province are typically more established with greater capital under management, and therefore we could postulate that such investors will be more sophisticated and able to incur extra risks of inter-provincial investment. On the other hand, investors with offices in more than 1 province are less likely to have a need to invest outside their provinces of residence, for the simple reason that their geographic coverage is broader (some investors have offices in as many as 6 of the 10 provinces). In Appendix A we explain how we record the office of location of investors with offices in more than 1 province. As well, it is noteworthy that only 3347 of the 13,729 transactions were derived from firms that had offices in more than one province.

Province-Specific Factors: Smaller provinces with fewer investors (such as the Maritime Provinces: Newfoundland, New Brunswick, Nova Scotia and Prince Edward Island) are likely to have more investors from other provinces. Alberta and Newfoundland investees (the two provinces without LSVCCs, as discussed in subsection 3.2) are more likely to have investors from other provinces. Quebec, as a French-speaking civil law province, likely has fewer non-resident investors.

Year of Investment: Inter-provincial investment activity is expected to increase over time as investors become more sophisticated, and information sharing and strategic networks develop over time. There could be an increasing role of information technology in expanding the geographic reach of venture capital and other forms of private equity; that is, the meaning of "geographic proximity" could be changing that would lead one to expect the importance of inter-provincial activity to continue to grow. Inter-provincial

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31 Gompers (1995); Gompers and Lerner (1999).

investment may also be expected to be greater in the bubble years of 1999 and 2000, as there was a surplus of capital chasing fewer deals.[32]

Transaction-Specific Factors: The type of security (common equity, preferred equity, convertible preferred equity, debt, convertible debt, warrants, debt and common equity, debt and preferred equity, and other combinations of securities), staging, and syndication are expected to be correlated with the likelihood of inter-provincial investment, but not expected to be determinants of inter-provincial investment (i.e., the causal connection is ambiguous). Syndicated investments are more likely to be inter-provincial as syndication facilitates due diligence, risk sharing and monitoring.[33] Staging frequency is related to monitoring intensity, and more frequent staging is therefore more likely to be correlated with intra-provincial investments. Securities that provide priority over the entrepreneur in bankruptcy (debt and preferred equity) are more likely to be correlated with the inter-provincial investments.[34]

4. Data

The data used in this study are from Macdonald & Associates Limited. Macdonald & Associates has built the most comprehensive database on venture capital and private equity activity in Canada. We consider 13729 investments over the period 1991 (1st quarter) – 2003 (1st quarter). Transactions are from numerous different types of investors: corporate, institutional, government, private (typically limited partnerships), labour-sponsored venture capital corporations (LSVCCs), and "other" types (investors with an interest in specific private equity deals, but without a permanent market presence). The types of investee firms in the database are also broad in scope: various stages of development (start-up, expansion, buyout, turnaround and "other" not specifically identified), industries (life-sciences, other high tech, and traditional non-high tech), and whether the investee firm is privately held or publicly traded on a stock exchange. A wide variety of securities appear in the data (common equity, preferred equity, convertible preferred equity, debt, convertible debt, warrants, mixes of debt and common equity, mixes of preferred equity and common equity, and other combinations) and deal types (staging, syndication, and amounts invested ranging from less than $10,000 to more than $100,000,000).

The data are exhaustively summarized in Appendix B (Tables A1-A10) for all types of investors, entrepreneurs, years of investment, amounts of investment, and other specifics of the transaction (see Appendix B for details).

A snapshot of the complete dataset for all 13,729 transactions is provided in Figure 5. Figure 5 shows a majority of investment activity (see Table A1 for details) is intra-provincial. For all types of investors and entrepreneurial firms, in terms of the numbers of investments

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32 Gompers and Lerner (2000).

33 Lerner (1994).

34 Prior work is consistent with the proposition that convertible preferred equity is used more often by sophisticated investors (Gompers, 1998; Kaplan and Stromberg, 2000). If sophistication is related to the frequency of use of convertibles, and to the frequency of inter-provincial investments, then we would of course expect convertible securities and inter-provincial investments to be correlated.

(13,729 transactions), 84.42% of investments involved an investor and entrepreneur that resided in the same province. In terms of the total value of these transactions ($20,193,896,909 in 1997 dollars), 61.15% of the investment value was intra-provincial. The investee firms in three provinces (Alberta, Newfoundland, and Prince Edward Island) received capital from non-resident investors in a majority of the investments. Tables A1-A10 provide extensive details for each province and type of transaction. Some of these details are also discussed in the text of the Appendix.

Table 1 provides a detailed summary of the data. The proportions of intra-provincial investments are explicitly presented for a number of different investor, investee, and transaction-specific characteristics. Univariate comparison tests are also provided. The statistically significant test statistics indicate the following (please refer to Table 1 for details):

- Inter-provincial investing (in which the entrepreneur and investor are not in the same province) is more likely in 1999-2003 relative to 1991-1998 (Tests #11-13), syndicated investments (Test #14), preferred equity and convertible preferred equity investments (Tests #26 and 27), and entrepreneurs resident in British Columbia, Alberta, Saskatchewan, Newfoundland, New Brunswick, Nova Scotia, and Prince Edward Island (while the frequency of inter-provincial investments in Manitoba is similar to the national average) (Tests # 35-52).

- Intra-provincial investing (in which the entrepreneur and investor are in the same province) is more likely for turnaround stage firms (Test #3), firms in traditional industries (as opposed to life science and other types of high tech firms) (Test #6), institutional, government and labour-sponsored investors (Tests # 8-10), more likely for first-round investments as opposed to follow-on investments (Tests # 15-17), smaller deal sizes (Tests #18-25), debt investments (Tests #28, 31), and for entrepreneurs resident in Ontario and Quebec (Tests #35-52).

Table 2 presents a matrix of correlation coefficients. The reported correlation coefficients for the first column between the proportion of intra-provincial investment and the other variables are consistent with the conclusions drawn from the comparison of proportion tests in Table 1. The variables in Table 2 are used in the next section to further explore the robustness of the univariate test statistics by analyzing the determinants of inter- versus intra-provincial investment in a multivariate context. The relatively small correlation coefficients across the variables indicate that we do not have a concern with collinearity problems amongst the considered explanatory variables (however, other explanatory variables are not used as the correlations were much higher, as discussed in Appendix A).

5. Multivariate Logit Tests

Our interest in this section is in explaining the presence of inter- versus intra-provincial investment decisions. To avoid an unnecessary complication in the presentation of the results, we present the empirical methods that we use in Appendix A. We present statistical tables with econometric regression in Tables 3-7. Table 3 considers the whole dataset of all investors and all entrepreneurs (13729 transactions). As a check on the robustness of the results in Table 3, in Tables 4-7 we consider subsamples of the data for certain provinces only, as discussed below.

Table 3 presents the regressions for all types of investors and investees, for all years, and for all provinces (the complete sample of 13,729 transactions). The variable being explained in the Table is the likelihood that an entrepreneurial firm and investor reside in the same province. Five models are presented in Table 3 to explicitly show the robustness of the results to different sets of explanatory variables. Model 5 presents the complete set of right-hand-side variables. As the inclusion of different explanatory variables does not materially affect the results, we focus the discussion on model 5. For model 5 we present the logit coefficient estimates, t-statistics to show statistical significance, and the marginal effects to show economic significance. The marginal effects show the increase (for positive numbers) in the probability of an intra-provincial investment for each given right-hand-side variable.

Model 5 in Table 3 indicates that government funds and LSVCCs are 4% more likely to carry out intra-provincial investments relative to inter-provincial investments, as expected (see our discussion in section 3(c)), and this result is significant at the 1% level of significance.

Publicly traded companies are 1% more likely to be inter-provincial investments. While this result is statistically significant, we might have expected greater economic significance. A greater amount of information is typically known about publicly traded companies. But referring back to Test #4 in Table 1, recall that 85% of private investments were intra-provincial, and 83% of investments in publicly traded companies were intra-provincial. The comparison test was not statistically significant. In the more rigorous multivariate context that simultaneously controls for many factors, we do find a statistically significant difference between privately held and publicly traded securities, but again, the magnitude of the difference is not large.[35] Note as well that the correlation between deal size (in logs) and the variable for public companies is only 0.07 (see Table 2). The statistical significance of the estimates does not depend on the simultaneous inclusion of the public company and deal size variables in the same model (see the alternative specifications in Table 2). The economic significance on the public company variable is about twice as large in models 1-3 relative to models 4 and 5, but the difference is due to the inclusion of the variables for the provinces and not the deal size variable (see model 3 versus model 4).

A somewhat unexpected finding in Table 3 is that turnaround investments are 8% more likely to be intra-provincial investments (relative to earlier start-up and expansion stage investments). In section 3 we postulated that companies in earlier stages of development would more likely be intra-provincial investments. The evidence is suggestive that the risks associated with turnaround transactions are greater than other types of transactions.[36]

Equally surprising is the finding that high tech companies are more likely to be inter-provincial investments than companies in non-tech industries. Problems of informational asymmetries and agency costs are widely regarded to be more pronounced among high tech firms. We would therefore expect investors and entrepreneurs more often to be domiciled in the same province. One explanation for this result is that investors that do actually finance high

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[35] Note that our evidence which compares private versus publicly traded securities in this paper is based on a relatively small number of public equity investments. Please refer to our companion paper (Cumming, Kaul and Mehrotra, 2003) for an analysis of segmentation versus integration of publicly traded companies in Canada.

[36] The buyout coefficient is also significant in Model 3; however, that result is not robust to the inclusion of different right-hand-side variables.

tech firms have superior information networks (e.g., strategic alliances with other investors or consultants that can facilitate the investment) to lower the agency costs and information asymmetries associated with investment in high tech firms.[37]

The data indicate that entrepreneurial firms that require more capital are more likely to receive that capital from an investor domiciled in a different province. An extra $1,000,000 in capital increases the probability of inter-provincial investment by 6%.[38] Entrepreneurial firm capital requirements are therefore a very economically and statistically significant determinant of the probability of inter- versus intra-provincial investment.

The data also indicate that the number of provinces in which the investor has offices is positively related to the probability that the investor carries out intra-provincial investments (with each extra office, there is a 3% reduction in the probability of inter-provincial investment). As mentioned, some of the investors in the dataset had offices in as many as 6 of the 10 provinces. The need to consider entrepreneurs domiciled in other provinces naturally diminishes when geographic scope of office location is more complete.

All of the variables that capture province-specific effects in the analysis of the complete set of data are statistically significant. It is noteworthy that the Alberta and Maritime variables are negative and significant (indicating inter-provincial investments are more likely for entrepreneurs in those provinces relative to the others), whereas the variables for the other provinces are positive and significant (indicating intra-provincial investments are more likely for entrepreneurs in those provinces relative to the others). These results are consistent with the legal and institutional differences across the provinces discussed in subsection 3(b).

Finally, note that the year of investment matters. Controlling for the above mentioned factors, in 2002, 2001 and 1993 there was relatively more frequent intra-provincial investment. These were years of "bust" periods in private equity investment. A natural interpretation is that intra-provincial investment activity increases when economic activity is in decline. At this point in time with the available data, we cannot conclude that the role of information technology is expanding the geographic reach of venture capital and other forms of private equity.

Tables 4, 5, 6 and 7 present regressions similar to those reported in Table 3 for the subset of Ontario, Quebec, British Columbia and Alberta entrepreneurial firms, respectively. We briefly discuss the main differences when one examines the results of each province independently.

The first main difference is that fewer coefficients are significant in the Ontario subsample (Table 4). The likely reason is that a majority of investors have offices in Ontario, and that the need to raise outside capital is significantly diminished for Ontario entrepreneurial firms.

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37 Agency problems in entrepreneurial finance are widely regarded to be more pronounced for high tech firms (see, e.g., Gompers, 1995; Gompers and Lerner, 1999, 2001).

38 The calculation is Log($1,000)*(-2%). Note that the deal size values in the data are expressed in thousands of dollars, so that $1,000 in the calculation is actually $1,000,0000.

The second main difference is in Quebec results. The Quebec regressions (Table 5) show very similar results to the full sample of all provinces (Table 3), but with one exception. The number of provinces in which the investor has offices is positive and significant in Table 3, but negative and significant in Table 5. Referring back to Table 2, note that the correlation between the number of offices and the variable for Quebec was -0.29, but positive in the other provinces (except Manitoba). Therefore, the data indicate Quebec investors are much more regionally isolated (less likely to have offices in multiple jurisdictions), as might be expected (for reasons discussed above in section 3).

The final main difference is in the year effects in Alberta versus Quebec. Inter-provincial investing has been increasing over time in Alberta, while intra-provincial investing has been increasing over time in Quebec. The degree to which year effects matter to cross-province investment activity therefore differs by province.

As a result of a comparative dearth of data from the other provinces, we only present regression analyses on the subsamples of data for Ontario, Quebec, British Columbia and Alberta entrepreneurial firms. It is possible to run regressions for some of the other provinces (or combinations of the other provinces) but only with a subset of the explanatory variables used in the reported tables. Alternative specifications are available upon request.

6. The Scope of the Data and Generalizations that can be drawn from the Empirical Analysis

There are certain limitations associated with the analysis of private equity investments carried out in this paper. First, the coverage of the data is obviously not 100% of all transactions in Canada. The CVCA covers industries traditionally targeted by venture capital and private equity funds. The CVCA covers the following high tech industries: biotechnology, medical/health related, communications, computer related, Internet related, electronics and "other" technology. The CVCA also covers the following traditional industries: consumer related, manufacturing and "miscellaneous".[39] Certain industries like mining and oil and gas are not covered in the database, and to our knowledge, systematic data on intra- versus inter-provincial investment in these and other industries do not exist in Canada.

Second, we stress that the data are focused on private equity (limited partnerships, corporate venture funds, LSVCCs, certain institutional investors that directly invest in entrepreneurial firms,[40] government venture programs, and "other" types of investors with an interest in specific private equity deals, but without a permanent market presence.[41] The data do not comprise investments from mutual funds, hedge funds, banks and any other individual or institutional investor that does not fit within the scope of investors covered by Macdonald & Associates Limited. Based on the empirical tests carried out in this paper, the data are consistent with the view that there is significantly less home bias for mutual funds, hedge funds, and other

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39 See http://www.cvca.ca/statistical_review/table_3x2002.html.

40 The identity of any given investor is not specifically revealed in the raw data (whereby each transaction cam be observed) from Macdonald and Associates, Ltd., for reasons of confidentiality. A list of investors that are members of the Canadian Venture Capital Association is available at http://www.cvca.ca/full_members/index.html.

41 Again, specific identities are not revealed for reasons indicated, *ibid.*

investors of publicly traded companies. Please refer to our companion paper (Cumming, Kaul and Mehrotra, 2003) for an analysis of regional segmentation in Canadian publicly equity markets.

Third, we do not know exact intra-province location and rural versus urban investments in Canada. Ideally, we would like to know the exact location. Nevertheless, we believe the intra- versus inter-provincial test is the most appropriate one, as the institutional barriers to inter-provincial investment likely outweigh a measure of geography based on miles.

Fourth, the data cover investments and not sales of investments through initial public offerings (IPOs) and acquisitions, etc. (see Cumming and MacIntosh, 2003a, b). Macdonald & Associates Limited believe (based on anecdotal evidence) that sale transactions more often involve sales to new investors resident in different provinces (or to foreign investors). Systematic data on sales that comprise information on the location of the investor and entrepreneur are in the process of being recorded by Macdonald & Associates, and this study will be updated when those data become available.[42] Nevertheless, despite these limitations, the breadth of transactions in terms of the heterogeneity of investors, entrepreneurs and types of transactions does enable us to extrapolate certain generalizations beyond the realm of the private equity market. For example, our evidence herein that larger transactions are more often inter-provincial is very consistent with the anecdotal evidence that sale transactions are more often inter-provincial (and/or involve foreign investors). For the most part, however, the results in the paper should be considered to apply to the context of private equity investment only, and not private equity exits.

Despite some limitations, Macdonald & Associates Limited's database is the best source of information for private equity investments in Canada, and a more complete database than comparable private equity databases from other countries, including Europe and the United States. As well, to our knowledge, no other database of any kind (for either publicly traded and/or privately held companies) matches the geographic location of Canadian investors and investees. The very high quality of the Macdonald & Associates Limited database enables a unique and significant amount of information to be gleaned about intra- versus inter-provincial investment activity in Canada. Transactions are from numerous different types of investors: corporate, institutional, government, private (typically limited partnerships), labour-sponsored venture capital corporations (LSVCCs), and "other" types of investors with an interest in specific private equity deals, but without a permanent market presence. The types of investee firms in the database are also broad in scope: various stages of development (start-up, expansion, buyout, turnaround) industries (life-sciences, other high tech, and traditional non-high tech), and whether the investee firm is privately held or publicly traded on a stock exchange. A wide variety of securities appear in the data (common equity, preferred equity, convertible preferred equity, debt, convertible debt, warrants, mixes of debt and common equity, mixes of preferred equity and common equity, and other combinations) and deal types (staging, syndication, and amounts invested ranging from less than $10,000 to more than $100,000,000).

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42 The exact date when these data will become available is unknown. As these data are important for documenting integration versus segmentation in private equity exit transactions, the authors have asked Macdonald and Associates, Ltd., to make these data available as soon as possible.

7. An Interpretation of the Evidence in View of Canadian Securities Regulation

There are two different ways of interpreting the data from the perspective of provincial versus federal securities regulation.

On the one hand, one may interpret the evidence in favor of regional securities regulators and regulations. A significant majority of private equity investments are carried out by investors and investees resident in the same province, and therefore local regulations can be tailored to meet the needs of this local market. In the U.S., for example, despite the federal Securities and Exchange Commission, there is a continuing state role in regulating intra-state and exempt offerings.[43]

On the other hand, one may interpret the evidence in favor of a national regulator. "Home-bias" is present in U.S. venture capital markets, as well as among U.S. mutual funds. Generally, it is well documented that there is a strong informational advantage to investing in geographically proximate companies, and both venture capitalists and mutual funds in the U.S. tend to earn higher returns when a greater proportion of their portfolio of investees was geographically proximate. The existence of a home bias is not a sufficient condition to conclude that securities markets should be regulated differently in different regions and/or that the identity of the regulator should be different for different regions. For example, the U.S. does exhibit a significant degree of home bias in private equity markets, but the U.S. also has a uniform securities act and a single federal regulatory body (albeit, there is a continuing state role in regulating intra-state and exempt offerings, as mentioned immediately above). Differences in regulations across provinces may in fact exacerbate the degree of home bias (as discussed above in subsection 3(b)). One interpretation of the different regression results across Tables 4-7 is that different province-specific regulations give rise to differences in the likelihood of inter- versus intra-provincial investment in different provinces.

It is possible to use the regression results to identify types of transactions for which harmonized securities regulations would be more advantageous. It is more important for transactions for which inter-provincial investments are more likely to be regulated in a similar way across provinces. We have empirically demonstrated significant differences in the likelihood of intra- versus inter-provincial investing depending on numerous firm- and transaction-specific characteristics. We also documented differences in the likelihood of intra-versus inter-provincial investing over time, as well as differences depending on the province. Inter-provincial investing (in which the entrepreneur and investor are not in the same province) is more likely when the investee firm is publicly traded, in 1999-2003 relative to 1991-1998, in syndicated investments, in preferred equity and convertible preferred equity investments, and in investments where the entrepreneur is resident in British Columbia, Alberta, Saskatchewan, Newfoundland, New Brunswick, Nova Scotia, or Prince Edward Island (while the frequency of inter-provincial investments in Manitoba is similar to the national average). Intra-provincial investing (in which the entrepreneur and investor are in the same province) is more likely for turnaround stage firms, firms in traditional industries (as opposed to life science and other types of high tech firms), government and labour-sponsored investors, first-round investments as opposed to follow-on investments, smaller deal sizes, debt investments, and for entrepreneurs

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[43] See, for example, Seligman (2003) for a description of these state regulations.

resident in Ontario and Quebec. The exact change in the likelihood of intra- versus inter-provincial investing was explicitly documented above in sections 4 and 5, and in Tables 1-7.

Our objective in this paper is not to advance a normative position; rather, our primary goal is to provide factual information about the extent of inter- versus intra-provincial investment activity, and the factors that explain the probability of cross-border investment.

8. Conclusion

This paper presented evidence on the frequency with which investors and entrepreneurs are located in different provinces. For all types of investors and entrepreneurial firms, in terms of the numbers of investments (13,729 transactions), 84.42% of investments involved an investor and entrepreneur that resided in the same province. In terms of the total value of these transactions ($20,193,896,909 in 1997 dollars), 61.15% of the investment value was intra-provincial.

This paper also provided univariate and multivariate tests that showed inter-provincial investing (in which the entrepreneur and investor are not in the same province) is more likely when the investee firm is publicly traded, more likely in 1999-2003 relative to 1991-1998, syndicated investments, preferred equity and convertible preferred equity investments, and entrepreneurs resident in British Columbia, Alberta, Saskatchewan, Newfoundland, New Brunswick, Nova Scotia, and Prince Edward Island (while the frequency of inter-provincial investments in Manitoba is similar to the national average). Intra-provincial investing (in which the entrepreneur and investor are in the same province) is more likely for turnaround stage firms, firms in traditional industries (as opposed to life science and other types of high tech firms), government and labour-sponsored investors, more likely for first-round investments as opposed to follow-on investments, smaller deal sizes, debt investments, and for entrepreneurs resident in Ontario and Quebec. The economic and statistical significance of each of these effects was explicitly assessed in the presentation of the results in the body of this paper.

The evidence in this paper can be interpreted in various ways, either to advance a case for differences in provincial securities regulations and regulators, or for a uniform national rules and a single regulator, depending on the aspects of the data and institutional environment that are stressed. We outlined different arguments in support of both positions.

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Figure 1. Venture Capital Under Management by Investor Type in Canada: 1992-2002

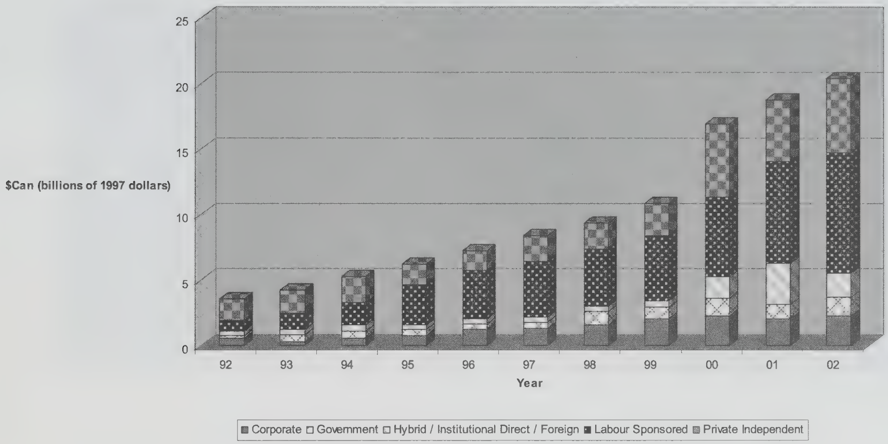


Figure 2a. Distribution of Venture Capital Finance in Canada, 1977-2002

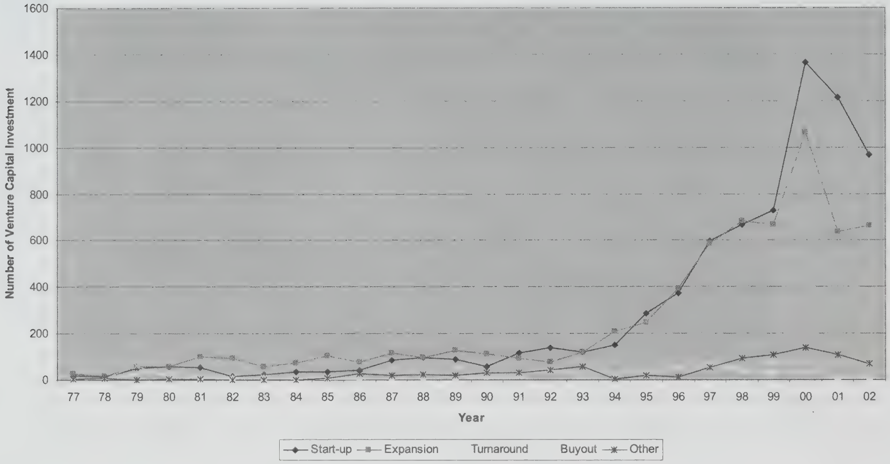


Figure 2b. Distribution of Venture Capital Finance in Canada, 1977-2002

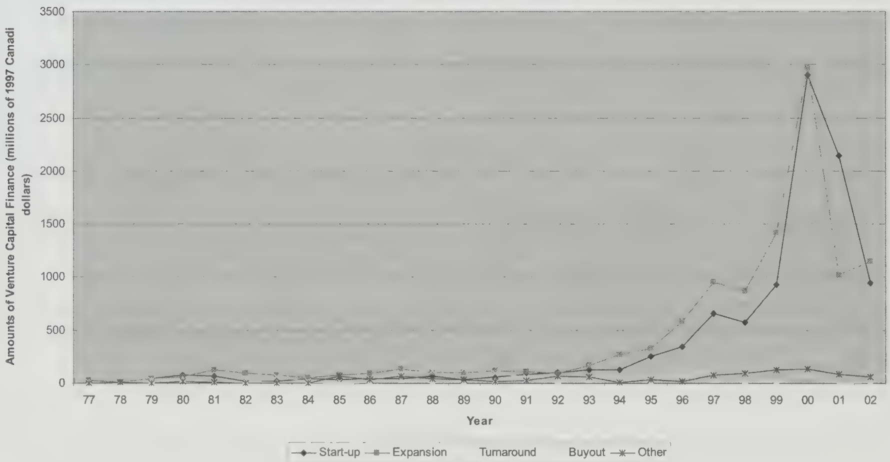


Figure 3a. Geographic Distribution of Venture Capital in Canada: 1977-2002

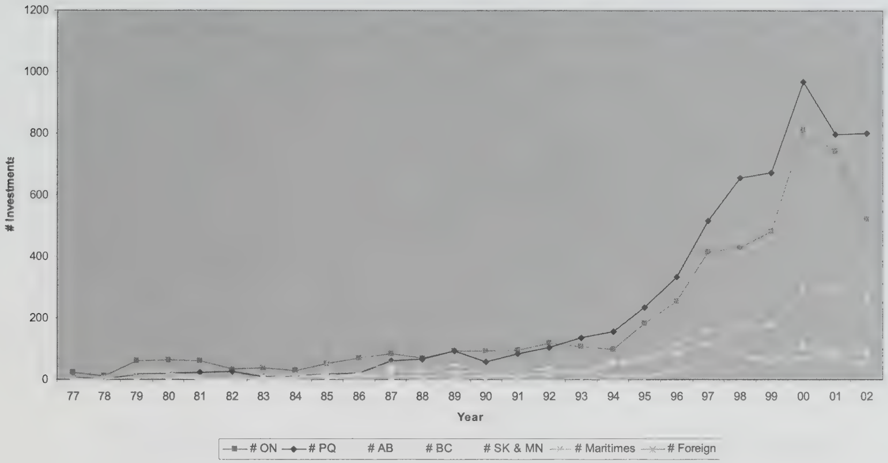


Figure 3b. Geographic Distribution of Venture Capital in Canada: 1977-2002

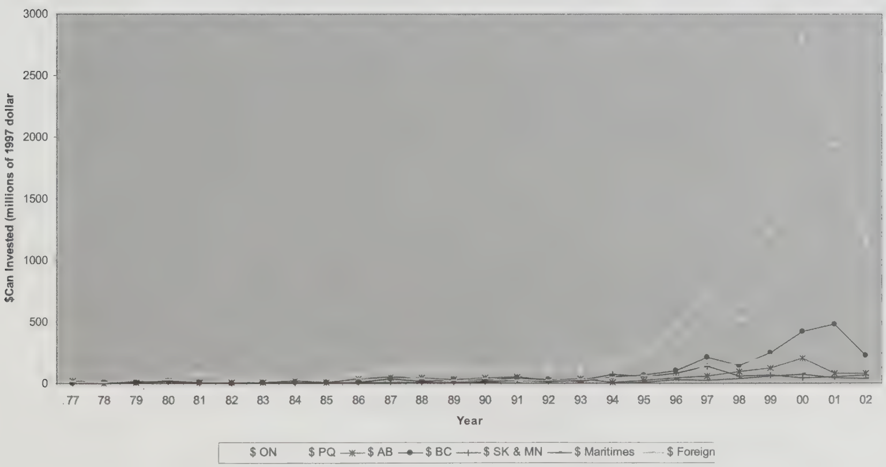


Figure 4a. Distribution of Venture Capital in Canada, 1985 - 2002

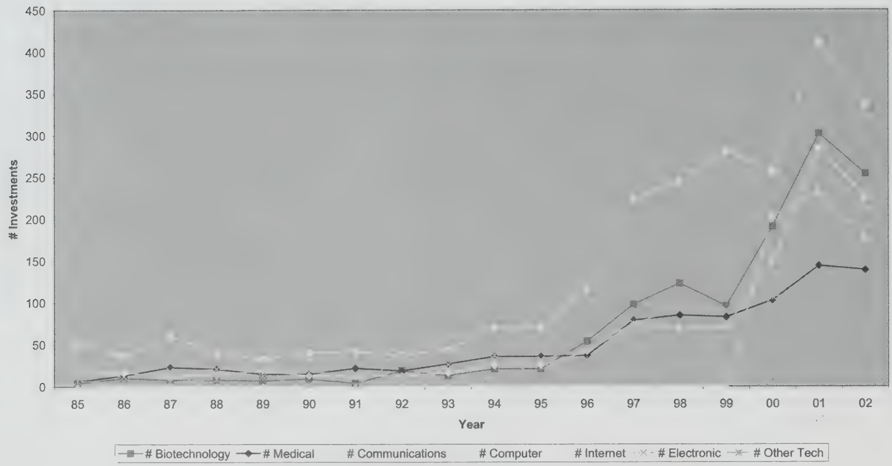


Figure 4b. Distribution of Venture Capital in Canada, 1985 - 2002

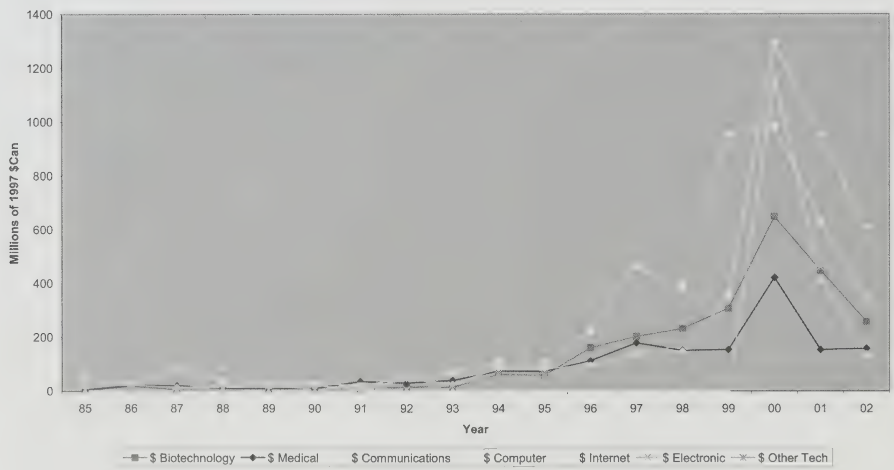


Figure 4c. Distribution of Venture Capital Finance in Canada, 1977 - 2002

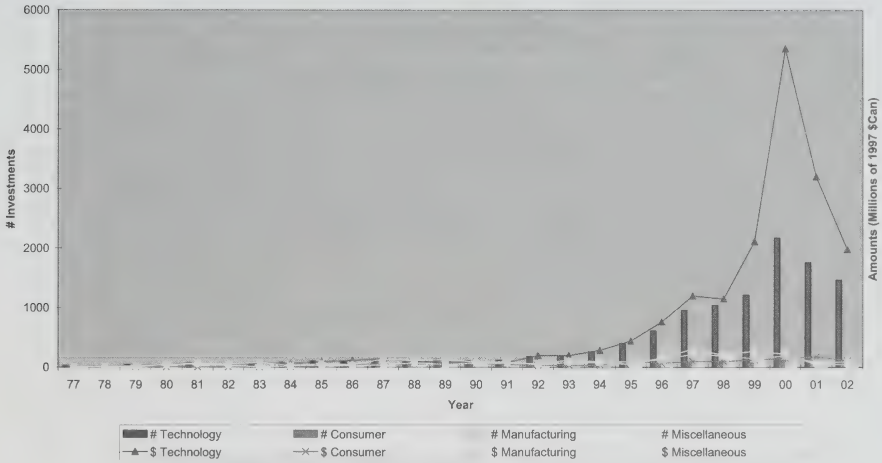
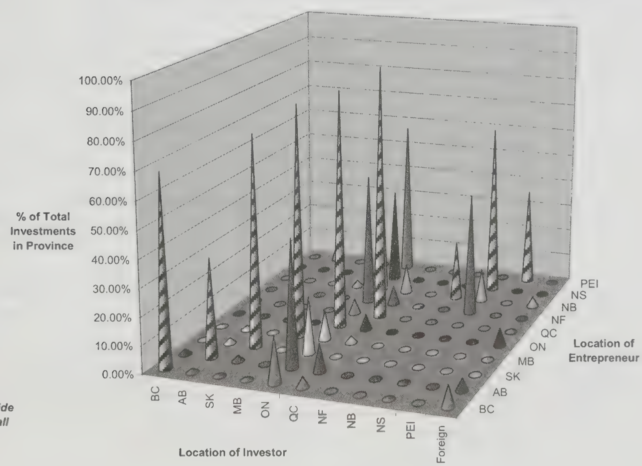


Figure 5. Location of All Investors and All Entrepreneurs



Important:
Tables A1 - A10 provide extensive details on all aspects of the data.

Table 1. Comparison of Proportions Tests for Proportions of Investments where Entrepreneurs and Investors are in the Same Province

This table reports comparisons of proportions tests of the number of times investments occurred in which investors entrepreneurs were in the same province as a proportion of the total number of financings for the listed characteristics of the venture capitalist, entrepreneur, and financing arrangement. A positive (negative) and significant number indicates that the top number is a greater (smaller) proportion of investors and entrepreneu were in the same province. *, **, *** Significant at the 10%, 5%, and 1% levels, respectively.

	#	Proportion	Proportion Equal?
1. Seed Stage versus Expansion Stage			
Seed Stage	4967	0.83	-0.65
Expansion Stage	3944	0.84	
2. Seed Stage versus Buyout Stage			
Seed Stage	4967	0.83	-0.84
Buyout Stage	410	0.85	
3. Seed Stage versus Turnaround Stage			
Seed Stage	4967	0.83	-9.35***
Turnaround Stage	654	0.97	
4. Privately Held versus Publicly Traded Entrepreneurs			
Privately Held	8748	0.85	1.42
Publicly Traded	1484	0.83	
5. Life Sciences versus Other types of High-Tech			
Life Sciences	2082	0.81	-1.01
High Tech	4544	0.82	
6. Life Sciences versus Traditional (non-High Tech)			
Life Sciences	2082	0.81	-8.28***
Traditional	3606	0.89	
7. Limited Partnership VCs versus Corporate Investors			
Private Independent Limited Partnerships	2753	0.82	-1.18
Corporate	1014	0.83	
8. Limited Partnership VCs versus Government Investors			
Private Independent Limited Partnerships	2753	0.82	-14.73***
Government	1722	0.97	
9. Limited Partnership VCs versus Institutional Investors			
Private Independent Limited Partnerships	2753	0.82	-4.52***
Institutional	1144	0.87	
10. Limited Partnership VCs versus LSVCCs			
Private Independent Limited Partnerships	2753	0.82	-12.52***
LSVCCs	3404	0.92	
11. Investment Years 1991 - 1994 versus 1995 - 1998			
1991 - 1994	962	0.89	1.63
1995 - 1998	3243	0.87	
12. Investment Years 1991 - 1994 versus 1999 - 2000			
1991 - 1994	962	0.89	3.92***
1999 - 2000	3016	0.83	
13. Investment Years 1991 - 1994 versus 2001 - 2003(Q1)			
1991 - 1994	962	0.89	3.15***
2001 - 2003(Q1)	339	0.82	

	#	Proportion	Propo Equ
14. Syndication versus Non-Syndication			
Syndication	5477	0.80	-13.1
Non-Syndication	4755	0.90	
15. Initial Investment Round 1 versus Staged Rounds 2-5			
Round 1	3829	0.87	6.22
Rounds 2-5	5264	0.83	
16. Initial Investment Round 1 versus Staged Rounds 6-10			
Round 1	3829	0.87	4.58
Rounds 6-10	1036	0.82	
17. Initial Investment Round 1 versus Staged Rounds 11-15			
Round 1	3829	0.87	-0.
Rounds 11-15	103	0.88	
18. Amounts Invested <$100,000 versus $100,000 - $500,000			
<$100,000	1119	0.82	-6.0
$100,000 - $500,000	3782	0.89	
19. Amounts Invested <$100,000 versus $500,000 - $1,000,000			
<$100,000	1119	0.82	-3.6
$500,000 - $1,000,000	1916	0.87	
20. Amounts Invested <$100,000 versus $1,000,000 - $5,000,000			
<$100,000	1119	0.82	-0.
$1,000,000 - $5,000,000	2948	0.82	
21. Amounts Invested <$100,000 versus >$5,000,000			
<$100,000	1119	0.82	8.0
>$5,000,000	467	0.63	
22. Deal Size <$100,000 versus $100,000 - $500,000			
<$100,000	610	0.93	0.
$100,000 - $500,000	2486	0.92	
23. Deal Size <$100,000 versus $500,000 - $1,000,000			
<$100,000	610	0.93	2.6
$500,000 - $1,000,000	1483	0.89	
24. Deal Size <$100,000 versus $1,000,000 - $5,000,000			
<$100,000	610	0.93	4.7
$1,000,000 - $5,000,000	3619	0.86	
25. Deal Size <$100,000 versus >$5,000,000			
<$100,000	610	0.93	11.0
>$5,000,000	2034	0.71	
26. Investor Has Offices in >1 Province versus only 1 Province			
Investor has offices in more than 1 province	2968	0.89	19.9
Investor has offices in 1 province only	7264	0.70	

Table 1 continues on the following p

Table 1 (Continued). Comparison of Proportions Tests for Proportions of Investments where Entrepreneurs and Investors are in the Same Province

le reports comparisons of proportions tests of the number of times investments occurred in which investors entrepreneurs were in the same province as a proportion of the total number of financings for the listed eristics of the venture capitalist, entrepreneur, and financing arrangement. A positive (negative) and significant number indicates that the top number is a greater (smaller) proportion of investors and eneurs were in the same province. *, **, *** Significant at the 10%, 5%, and 1% levels, respectively.

	#	Proportion	Proportion Equal?		#	Proportion	Proportion Equal?
nmon Equity versus Preferred Equity				40. ON Entrepreneurs versus NF Entrepreneurs			
Common Equity	3212	0.85	3.73***	ON	3530	0.87	NA
Preferred Equity	878	0.80		NF	0	0.00	
nmon Equity versus Convertible Preferred Equity				41. ON Entrepreneurs versus NB Entrepreneurs			
Common Equity	3212	0.85	3.76***	ON	3530	0.87	8.14***
Convertible Preferred Equity	893	0.80		NB	18	0.21	
nmon Equity versus Debt				42. ON Entrepreneurs versus NS Entrepreneurs			
Common Equity	3212	0.85	-4.93***	ON	3530	0.87	6.97***
Debt	1630	0.90		NS	101	0.63	
nmon Equity versus Convertible Debt				43. ON Entrepreneurs versus PEI Entrepreneurs			
Common Equity	3212	0.85	0.40	ON	3530	0.87	3.39***
Convertible Debt	1209	0.84		PEI	5	0.36	
nmon Equity versus Warrants				44. ON Investors versus BC Investors			
Common Equity	3212	0.85	0.42	ON	3530	0.79	-14.01***
Warrants	53	0.83		BC	999	0.98	
nmon Equity versus Mixes of Debt and Common Equity				45. ON Investors versus AB Investors			
Common Equity	3212	0.85	-5.17***	ON	3530	0.79	1.12
Debt and Common	529	0.93		AB	156	0.75	
nmon Equity versus Mixes of Preferred and Common Equity				46. ON Investors versus SK Investors			
Common Equity	3212	0.85	-1.23	ON	3530	0.79	-3.07***
Preferred and Commonn	187	0.88		SK	146	0.90	
nmon Equity versus Other Combinations				47. ON Investors versus MB Investors			
Common Equity	3212	0.85	3.58***	ON	3530	0.79	-5.20***
Other	1641	0.81		MB	315	0.91	
Entrepreneurs versus BC Entrepreneurs				48. ON Investors versus QC Investors			
ON	3530	0.87	13.50***	ON	3530	0.79	-19.85***
BC	999	0.69		QC	4962	0.94	
repreneurs versus AB Entrepreneurs				49. ON Investors versus NF Investors			
ON	3530	0.87	17.44***	ON	3530	0.79	NA
AB	156	0.36		NF	0	0.00	
Entrepreneurs versus SK Entrepreneurs				50. ON Investors versus NB Investors			
ON	3530	0.87	3.65***	ON	3530	0.79	-1.14
SK	146	0.76		NB	18	0.90	
Entrepreneurs versus MB Entrepreneurs				51. ON Investors versus NS Investors			
ON	3530	0.87	1.25	ON	3530	0.79	0.90
MB	315	0.84		NS	101	0.75	
Entrepreneurs versus QC Entrepreneurs				52. ON Investors versus PEI Investors			
ON	3530	0.87	-9.89***	ON	3530	0.79	-1.15
QC	4962	0.93		PEI	5	1.00	

Table 2. Correlation Matrix

This table presents the correlation coefficients between a dummy variable for investments with entrepreneurs and investors located in the same province, and a number of investor and entrepreneur characteristics, as well as the log of the deal size, and dumhe correlation coeffi province of residence of the entrepreneur, and dummy variables for the year of investment. These variables are used for the multivariate tests in the subsequent tables.

	Dummy Variable for Investor and Entrepreneur in Same Province	Dummy Variable for Government Investor or LSVCC	Dummy Variable for Public Company	Dummy Variable for Buyout Company	Dummy Variable for Turnaround Company	Dummy Variable for Tech Company (Life Science or Other High-Tech)	Log of the Total Deal Size	# Provinces in which Investor has Offices	Dummy Variable for Alberta Entrepreneur	Dummy Variable for Saskatchewan Entrepreneur	Dummy Variable for Manitoba Entrepreneur	Dummy Variable for Ontario Entrepreneur	Dummy Variable for Quebec Entrepreneur	Dummy Variable for New Brunswick Entrepreneur	Dummy Variable for Nova Scotia Entrepreneur	Dummy Variable for PEI Entrepreneur	Dummy Variable for Investment in 2003	Dummy Variable for Investment in 2002	Dummy Variable for Investment in 2001	Dummy Variable for Investment in 2000	Dummy Variable for Investment in 1999	Dummy Variable for Investment in 1998	Dummy Variable for Investment in 1997	Dummy Variable for Investment in 1996	Dummy Variable for Investment in 1995	Dummy Variable for Investment in 1994	Dummy Variable for Investment in 1993	Dummy Variable for Investment in 1992
Dummy Variable for Investor and Entrepreneur in Same Province	1.00																											
Dummy Variable for Government Investor or LSVCC	0.17	1.00																										
Dummy Variable for Public Company	-0.05	0.03	1.00																									
Dummy Variable for Buyout Company	0.01	0.01	0.02	1.00																								
Dummy Variable for Turnaround Company	0.08	0.15	0.00	-0.05	1.00																							
Dummy Variable for Tech Company (Life Science or Other High-Tech)	-0.06	-0.12	0.08	-0.11	-0.17	1.00																						
Log of the Total Deal Size	-0.15	-0.05	0.07	0.06	-0.15	0.25	1.00																					
# Provinces in which Investor has Offices	0.05	0.24	0.05	0.01	-0.05	0.13	0.16	1.00																				
Dummy Variable for Alberta Entrepreneur	-0.28	-0.09	0.05	0.01	-0.04	-0.05	0.02	0.03	1.00																			
Dummy Variable for Saskatchewan Entrepreneur	0.00	0.10	-0.01	0.04	-0.03	-0.05	-0.02	0.06	-0.02	1.00																		
Dummy Variable for Manitoba Entrepreneur	0.00	0.07	-0.02	-0.01	-0.03	-0.10	-0.06	-0.06	-0.04	-0.02	1.00																	
Dummy Variable for Ontario Entrepreneur	0.06	0.01	0.07	-0.02	-0.09	0.15	0.19	0.09	-0.12	-0.08	-0.12	1.00																
Dummy Variable for Quebec Entrepreneur	0.20	0.02	-0.11	0.03	0.17	-0.13	-0.22	-0.29	-0.19	-0.13	-0.19	-0.63	1.00															
Dummy Variable for New Brunswick Entrepreneur	-0.16	-0.02	-0.02	0.00	-0.02	0.02	0.01	0.03	-0.02	-0.01	-0.02	-0.05	-0.08	1.00														
Dummy Variable for Nova Scotia Entrepreneur	-0.07	-0.02	-0.04	0.00	-0.03	0.05	-0.04	0.04	-0.02	-0.01	-0.02	-0.07	-0.11	-0.01	1.00													
Dummy Variable for PEI Entrepreneur	-0.06	-0.01	0.00	0.05	-0.01	-0.01	-0.02	0.03	-0.01	0.00	-0.01	-0.02	-0.04	0.00	0.00	1.00												
Dummy Variable for Investment in 2003	0.00	0.01	-0.04	-0.03	-0.03	0.01	0.01	-0.01	0.00	0.04	0.01	-0.03	0.02	-0.01	-0.01	-0.01	1.00											
Dummy Variable for Investment in 2002	0.00	0.06	-0.07	-0.01	-0.03	0.06	0.10	0.00	-0.01	0.01	0.01	-0.04	0.01	0.01	0.01	-0.01	-0.07	1.00										
Dummy Variable for Investment in 2001	0.00	-0.02	-0.09	0.00	-0.04	0.11	0.08	0.01	-0.02	-0.03	0.05	0.01	-0.03	0.03	0.00	-0.01	-0.07	-0.15	1.00									
Dummy Variable for Investment in 2000	-0.02	-0.06	-0.03	-0.02	-0.04	0.09	0.09	-0.01	0.01	-0.01	0.00	0.02	-0.02	-0.01	0.01	0.02	-0.08	-0.18	-0.19	1.00								
Dummy Variable for Investment in 1999	-0.01	-0.02	0.03	0.02	0.03	0.01	0.02	0.03	-0.01	0.00	0.01	-0.01	0.01	0.00	0.01	0.00	-0.06	-0.14	-0.15	-0.17	1.00							
Dummy Variable for Investment in 1998	0.01	0.02	0.03	-0.04	0.03	-0.02	-0.09	0.00	0.00	-0.01	-0.03	-0.01	0.03	0.00	0.03	0.00	-0.06	-0.13	-0.14	-0.16	-0.13	1.00						
Dummy Variable for Investment in 1997	-0.01	0.04	0.06	-0.01	0.04	-0.03	-0.06	0.00	0.00	0.02	-0.01	0.01	0.01	-0.01	-0.01	0.00	-0.06	-0.13	-0.14	-0.15	-0.13	-0.12	1.00					
Dummy Variable for Investment in 1996	0.00	0.02	0.06	0.01	0.03	-0.04	-0.05	0.03	-0.01	0.03	-0.01	0.00	0.01	0.01	0.00	0.01	-0.04	-0.10	-0.10	-0.12	-0.10	-0.09	-0.09	1.00				
Dummy Variable for Investment in 1995	0.02	-0.01	0.07	0.02	-0.02	-0.07	-0.05	0.01	-0.01	-0.01	-0.01	0.01	0.01	-0.01	-0.02	-0.01	-0.04	-0.08	-0.08	-0.09	-0.08	-0.07	-0.07	-0.05	1.00			
Dummy Variable for Investment in 1994	0.02	0.00	0.03	0.01	0.01	-0.08	-0.04	-0.01	-0.01	0.00	-0.01	0.01	0.01	-0.01	-0.02	-0.01	-0.03	-0.07	-0.07	-0.08	-0.06	-0.06	-0.06	-0.04	-0.03	1.00		
Dummy Variable for Investment in 1993	0.02	-0.02	0.03	0.02	0.01	-0.10	-0.06	-0.03	0.01	0.00	-0.01	0.01	0.01	-0.01	-0.02	0.01	-0.03	-0.06	-0.07	-0.07	-0.06	-0.06	-0.05	-0.04	-0.03	-0.03	1.00	
Dummy Variable for Investment in 1992	0.01	-0.02	0.01	0.05	0.05	-0.12	-0.07	-0.02	0.06	-0.01	-0.01	0.03	-0.03	-0.01	-0.01	-0.01	-0.03	-0.06	-0.06	-0.07	-0.06	-0.05	-0.05	-0.04	-0.03	-0.03	-0.02	1.00

Table 3. Multivariate Logit Regressions for the Likelihood that the Entrepreneur and the Investor are in the Same Province

ependent variable: a dummy equal to one if the entrepreneur and the investor are located in the same province. The deal size is measured in thousands of Canadian dollars; other explanatory variables are as efined. 10450 observations (excluded: foreign investments and investments in which the location of the investor was unknown). *, **, *** Significant at the 10%, 5%, and 1% levels, respectively.

	Model 1		Model 2		Model 3		Model 4		Model 5		
	Coefficient	t-statistic	Coefficient	t-statistic	Coefficient	t-statistic	Coefficient	t-statistic	Coefficient	t-statistic	Marginal Effect
Constant	1.61	41.59***	1.73	26.94***	3.47	22.51***	2.19	10.93***	1.93	6.29***	0.13
ummy Variable for Government Investor or LSVCC	1.15	17.17***	1.07	15.82***	1.00	14.16***	0.67	8.51***	0.67	8.46***	0.04
Dummy Variable for Public Company	-0.48	-6.15***	-0.47	-5.92***	-0.44	-5.56***	-0.27	-3.00***	-0.22	-2.32**	-0.01
Dummy Variable for Buyout Company			0.09	0.53	0.30	1.70***	0.29	1.42	0.26	1.29	0.02
Dummy Variable for Turnaround Company			1.87	5.80***	1.74	5.37***	1.14	3.45***	1.16	3.50***	0.08
ummy Variable for Tech Company (Life Science or Other High-Tech)			-0.21	-3.01***	0.00	0.06	-0.27	-3.23***	-0.28	-3.32***	-0.02
Log of the Total Deal Size					-0.28	-13.77***	-0.29	-13.01***	-0.30	-13.01***	-0.02
# Provinces in which the Investor has Offices					0.10	3.42***	0.44	12.18***	0.45	12.29***	0.03
ummy Variable for Alberta Entrepreneur							-1.31	-9.39***	-1.31	-9.31***	-0.09
Dummy Variable for Saskatchewan Entrepreneur							0.48	1.86*	0.53	2.05***	0.04
Dummy Variable for Manitoba Entrepreneur							1.05	5.46***	1.06	5.47***	0.07
ummy Variable for Ontario Entrepreneur							1.78	17.32***	1.80	17.36***	0.12
Dummy Variable for Quebec Entrepreneur							2.11	20.39***	2.13	20.41***	0.14
Dummy Variable for New Brunswick Entrepreneur							-2.45	-7.83***	-2.47	-7.81***	-0.16
Dummy Variable for Nova Scotia Entrepreneur							-0.27	-1.26	-0.24	-1.11***	-0.02
Dummy Variable for PEI Entrepreneur							-2.49	-3.79***	-2.45	-3.76***	-0.16
Dummy Variable for Investment in 2003									0.23	0.73	0.02
Dummy Variable for Investment in 2002									0.45	1.67*	0.03
Dummy Variable for Investment in 2001									0.47	1.74*	0.03
Dummy Variable for Investment in 2000									0.36	1.34	0.02
Dummy Variable for Investment in 1999									0.17	0.63	0.01
Dummy Variable for Investment in 1998									0.24	0.87	0.02
Dummy Variable for Investment in 1997									0.04	0.13	0.00
Dummy Variable for Investment in 1996									0.09	0.32	0.01
Dummy Variable for Investment in 1995									0.38	1.19	0.03
Dummy Variable for Investment in 1994									0.41	1.19	0.03
Dummy Variable for Investment in 1993									0.80	2.16**	0.05
Dummy Variable for Investment in 1992									0.57	1.58	0.04
Model Diagnostics:											
Loglikelihood	-3679.01		-3639.50		-3537.44		-2942.92		-2931.38		
Chi-Square	358.40***		437.32***		641.54***		1830.59***		1853.67***		
Actual Outcomes	Predicted Outcomes		Predicted Outcomes		Predicted Outcomes		Predicted Outcomes		Predicted Outcomes		
	0	1	0	1	0	1	0	1	0	1	
0	0	1266	0	1266	0	1266	345	921	350	916	
1	0	9184	0	9184	0	9184	196	8988	192	8992	

Table 4. Multivariate Logit Regressions for the Likelihood that the Entrepreneur and the Investor are in the Same Province, Ontario Entrepreneurial Firms Only

Dependent variable: a dummy equal to one if the entrepreneur and the investor are located in the same province. The deal size is measured in thousands of Canadian dollars; other explanatory variables are as defined. Ontario entrepreneurs only. The number of provinces in which the investor has offices was necessarily excluded as all investors with offices in more than 1 province had invested in Ontario entrepreneurial firms (i.e., there was no variati in the dependent and independent variables). 3005 observations (also excluded: foreign investments and investments in which the location of the investor was unknown). *, **, *** Significant at the 10%, 5%, and 1% levels, respectively.

	Model 1		Model 2		Model 3		Model 4		
	Coefficient	t-statistic	Coefficient	t-statistic	Coefficient	t-statistic	Coefficient	t-statistic	Marginal Effe
Constant	1.66	21.97***	1.64	9.59***	1.67	5.20***	1.03	1.96**	0.05
Dummy Variable for Government Investor or LSVCC	2.22	11.37***	2.22	11.23***	2.22	11.19***	2.25	11.20***	0.11
Dummy Variable for Public Company	-0.05	-0.28	-0.10	-0.57	-0.10	-0.57	-0.32	-1.68*	-0.02
Dummy Variable for Buyout Company			0.75	1.57	0.75	1.57	0.75	1.53	0.04
Dummy Variable for Turnaround Company			1.22	1.67*	1.22	1.67*	1.19	1.61	0.06
Dummy Variable for Tech Company (Life Science or Other High-Tech)			-0.01	-0.04	0.00	-0.01	0.19	0.99	0.01
Log of the Total Deal Size					-0.005	-0.12	0.02	0.51	0.001
Number of Provinces in which the Investor has Offices					NA	NA	NA	NA	NA
Dummy Variable for Investment in 2003							-0.36	-0.62	-0.02
Dummy Variable for Investment in 2002							-0.02	-0.05	0.00
Dummy Variable for Investment in 2001							0.22	0.45	0.01
Dummy Variable for Investment in 2000							0.28	0.57	0.01
Dummy Variable for Investment in 1999							0.24	0.48	0.01
Dummy Variable for Investment in 1998							0.26	0.52	0.01
Dummy Variable for Investment in 1997							0.45	0.88	0.02
Dummy Variable for Investment in 1996							0.53	0.95	0.03
Dummy Variable for Investment in 1995							2.85	2.57**	0.14
Dummy Variable for Investment in 1994							0.26	0.42	0.01
Dummy Variable for Investment in 1993							0.91	1.39	0.04
Dummy Variable for Investment in 1992							2.49	2.24**	0.12
Model Diagnostics:									
Loglikelihood	-804.73		-801.23		-801.22		-784.87		
Chi-Square	202.08***		209.08***		209.10***		241.80***		
Actual Outcomes	Predicted Outcomes		Predicted Outcomes		Predicted Outcomes		Predicted Outcomes		
	0	1	0	1	0	1	0	1	
0	0	269	0	269	0	269	0	269	
1	0	2736	0	2736	0	2736	0	2736	

Table 5. Multivariate Logit Regressions for the Likelihood that the Entrepreneur and the Investor are in the Same Province, Quebec Entrepreneurial Firms Only

pendent variable: a dummy equal to one if the entrepreneur and the investor are located in the same province. The deal size is measured in thousands of Canadian dollars; other explanatory variables are as defined. Quebec trepreneurs only. 5152 observations (also excluded: foreign investments and investments in which the location of the investor was unknown). *, **, *** Significant at the 10%, 5%, and 1% levels, respectively.

	Model 1		Model 2		Model 3		Model 4		
	Coefficient	t-statistic	Coefficient	t-statistic	Coefficient	t-statistic	Coefficient	t-statistic	Marginal Effect
Constant	2.62	32.69***	3.21	21.64***	6.34	18.25***	5.16	10.82***	0.14
mmy Variable for Government Investor or LSVCC	0.99	7.29***	0.82	5.99***	1.06	7.07***	0.95	6.19***	0.03
Dummy Variable for Public Company	-0.96	-6.21***	-0.83	-5.24***	-0.68	-4.19***	-0.44	-2.57**	-0.01
Dummy Variable for Buyout Company			-0.04	-0.13	0.38	1.11	0.43	1.24	0.01
Dummy Variable for Turnaround Company			1.30	2.82***	1.04	2.25**	1.25	2.65***	0.03
mmy Variable for Tech Company (Life Science or Other High-Tech)			-0.87	-5.58***	-0.47	-2.88***	-0.81	-4.57***	-0.02
Log of the Total Deal Size					-0.455	-10.17***	-0.52	-10.92***	-0.014
# Provinces in which the Investor has Offices					-0.192	-3.38***	-0.17	-2.88***	-0.004
ummy Variable for Investment in 2003							2.60	4.43***	0.07
ummy Variable for Investment in 2002							2.38	5.67***	0.06
ummy Variable for Investment in 2001							2.51	5.95***	0.07
ummy Variable for Investment in 2000							2.10	5.30***	0.06
ummy Variable for Investment in 1999							2.09	5.10***	0.06
ummy Variable for Investment in 1998							2.12	5.03***	0.06
ummy Variable for Investment in 1997							1.43	3.57***	0.04
ummy Variable for Investment in 1996							1.25	3.01***	0.03
ummy Variable for Investment in 1995							1.01	2.40**	0.03
ummy Variable for Investment in 1994							1.71	3.25***	0.05
ummy Variable for Investment in 1993							2.12	3.59***	0.06
ummy Variable for Investment in 1992							0.32	0.65	0.01
Model Diagnostics:									
Loglikelihood	-1035.23		-1007.63		-945.17		-907.54		
Chi-Square	87.78***		142.99***		267.91***		343.16***		
Actual Outcomes	Predicted Outcomes		Predicted Outcomes		Predicted Outcomes		Predicted Outcomes		
	0	1	0	1	0	1	0	1	
0	0	277	0	277	0	277	1	276	
1	0	4875	0	4875	0	4875	3	4872	

Table 6. Multivariate Logit Regressions for the Likelihood that the Entrepreneur and the Investor are in the Same Province, British Columbia Entrepreneurial Firms Only										
Dependent variable: a dummy equal to one if the entrepreneur and the investor are located in the same province. The deal size is measured in thousands of Canadian dollars; other explanatory variables are as defined. British Columbia entrepreneurs only. 1158 observations (also excluded: foreign investments and investments in which the location of the investor was unknown). *, **, *** Significant at the 10%, 5%, and 1% levels, respectively.										
	Model 1		Model 2		Model 3		Model 4			
	Coefficient	t-statistic	Coefficient	t-statistic	Coefficient	t-statistic	Coefficient	t-statistic	Marginal Effe	
Constant	0.72	7.70***	0.56	3.74***	1.25	2.23**	1.10	1.34	0.05	
Dummy Variable for Government Investor or LSVCC	0.87	6.01***	0.86	5.95***	-3.77	-6.78***	-3.77	-6.74***	-0.18	
Dummy Variable for Public Company	-0.16	-0.99	-0.15	-0.95	-0.25	-1.09	-0.16	-0.63	-0.01	
Dummy Variable for Buyout Company			-0.24	-0.53	-0.78	-1.12	-0.88	-1.17	-0.04	
Dummy Variable for Turnaround Company			1.19	1.56	-0.62	-0.68	-0.69	-0.70	-0.03	
Dummy Variable for Tech Company (Life Science or Other High-Tech)			0.19	1.21	0.66	2.69***	0.75	2.83***	0.04	
Log of the Total Deal Size					-0.607	-8.18***	-0.63	-8.06***	-0.030	
# Provinces in which the Investor has Offices					2.737	12.86***	2.80	12.97***	0.134	
Dummy Variable for Investment in 2003							-0.62	-0.64	-0.03	
Dummy Variable for Investment in 2002							0.48	0.68	0.02	
Dummy Variable for Investment in 2001							0.52	0.74	0.02	
Dummy Variable for Investment in 2000							0.15	0.22	0.01	
Dummy Variable for Investment in 1999							-0.22	-0.30	-0.01	
Dummy Variable for Investment in 1998							-0.84	-1.12	-0.04	
Dummy Variable for Investment in 1997							-0.02	-0.02	0.00	
Dummy Variable for Investment in 1996							0.44	0.52	0.02	
Dummy Variable for Investment in 1995							0.47	0.51	0.02	
Dummy Variable for Investment in 1994							0.59	0.72	0.03	
Dummy Variable for Investment in 1993							1.04	0.96	0.05	
Dummy Variable for Investment in 1992							0.32	0.36	0.02	
Model Diagnostics:										
Loglikelihood	-651.26		-648.87		-295.22		-286.90			
Chi-Square	40.98***		45.74***		753.05***		769.68***			
Actual Outcomes	Predicted Outcomes		Predicted Outcomes		Predicted Outcomes		Predicted Outcomes			
	0	1	0	1	0	1	0	1		
0	0	309	0	309	234	75	237	72		
1	0	849	0	849	74	775	70	779		

Table 7. Multivariate Logit Regressions for the Likelihood that the Entrepreneur and the Investor are in the Same Province, Alberta Entrepreneurial Firms Only

ependent variable: a dummy equal to one if the entrepreneur and the investor are located in the same province. The deal size is measured in thousands of Canadian dollars; other explanatory variables are as defined. Alberta ntrepreneurs only. 360 observations (also excluded: foreign investments and investments in which the location of the investor was unknown). *, **, *** Significant at the 10%, 5%, and 1% levels, respectively.

	Model 1		Model 2		Model 3		Model 4		
	Coefficient	t-statistic	Coefficient	t-statistic	Coefficient	t-statistic	Coefficient	t-statistic	Marginal Effect
Constant	-0.09	-0.63	-0.23	-1.23	0.78	1.35	1.78	2.09**	0.41
ummy Variable for Government Investor or LSVCC	-0.99	-3.56***	-0.94	-3.33***	-1.92	-4.40***	-1.95	-3.76***	-0.45
Dummy Variable for Public Company	-0.49	-1.79*	-0.62	-2.17**	-0.56	-1.94*	-0.71	-2.00**	-0.16
Dummy Variable for Buyout Company			1.51	2.64**	1.47	2.44**	1.69	2.53**	0.39
Dummy Variable for Turnaround Company			0.62	0.42	0.51	0.36	-0.33	-0.19	-0.08
ummy Variable for Tech Company (Life Science or Other High-Tech)			0.16	0.69	-0.18	-0.75	0.41	1.35	0.10
Log of the Total Deal Size					-0.205	-2.73***	-0.16	-1.78*	-0.037
# Provinces in which the Investor has Offices					0.457	3.88***	0.58	4.29***	0.135
)ummy Variable for Investment in 2003							-2.65	-2.63***	-0.61
)ummy Variable for Investment in 2002							-2.70	-3.74***	-0.63
)ummy Variable for Investment in 2001							-2.20	-3.10***	-0.51
)ummy Variable for Investment in 2000							-2.08	-3.15***	-0.48
)ummy Variable for Investment in 1999							-2.76	-3.80***	-0.64
)ummy Variable for Investment in 1998							-2.21	-3.17***	-0.51
)ummy Variable for Investment in 1997							-3.10	-4.13***	-0.72
)ummy Variable for Investment in 1996							-1.99	-2.40**	-0.46
)ummy Variable for Investment in 1995							1.76	1.40	0.41
)ummy Variable for Investment in 1994							0.23	0.18	0.05
)ummy Variable for Investment in 1993							-0.45	-0.49	-0.11
)ummy Variable for Investment in 1992							0.06	0.07	0.01
Model Diagnostics:									
Loglikelihood	-232.79		-228.78		-216.80		-181.29		
Chi-Square	18.16***		26.19***		50.15***		121.17***		
Actual Outcomes	Predicted Outcomes		Predicted Outcomes		Predicted Outcomes		Predicted Outcomes		
	0	1	0	1	0	1	0	1	
0	217	0	213	4	170	47	177	40	
1	143	0	130	13	105	38	65	78	

Appendix A

Empirical Methods used in Section 5 and Tables 3-7

In this Appendix we provide details on the empirical methods used in section 5 of the paper. Tables 3-7 present binomial logit regressions of the likelihood that an investor and entrepreneur reside in the same province. Table 3 considers all provinces together. Tables 4, 5, 6 and 7 consider the subsamples for entrepreneurs resident in Ontario, Quebec, British Columbia and Alberta, respectively.[44] In each regression, the dependent variable is equal to one if the entrepreneur and investor reside in the same province. The independent variables are as follows:

- A dummy variable equal to 1 if the investor was an actual government fund or a LSVCC and 0 for private limited partnerships, institutional investors, and corporate investors. Separate variables for each investor type were not used to avoid collinearity bias.

- A dummy variable equal to 1 if the investee was a publicly traded firm and 0 for privately held firms.

- A dummy variable equal to 1 for buyout stage investee firms and 0 otherwise, and a dummy variable equal to 1 for turnaround stage investee firms and 0 otherwise. Separate dummies for start-up and expansion stage firms were suppressed to avoid problems arising from collinearity.

- A dummy variable equal to 1 for high tech investees (either life-science or other high tech) and 0 for firms in traditional industries (e.g., manufacturing, etc). Dummies for different industries were not used to avoid collinearity problems.

- The log of the total deal size (including all syndicated investment). Consistent with a large prior literature in financial economics, this variable is expressed in logs as the effect of larger sizes becomes smaller as size becomes larger. We use total deal size, and not the amount invested by a particular investor, as entrepreneurial firm capital requirements are exogenously determined by the financial needs of the entrepreneur. (As discussed below, certain other variables are not exogenous to the likelihood of inter-provincial investment activity.)

- Dummy variables for entrepreneurs resident in different provinces. Dummy variables for British Columbia and Newfoundland were suppressed in order to avoid perfect collinearity.

- Dummy variables for different investment years. A dummy variable for 1991 was suppressed to avoid perfect collinearity.

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[44] Subsamples from other provinces were not considered due to a comparative dearth of data from those provinces.

Regarding investors with offices in more than one province, note that we identify the province of domicile for the empirical analyses as follows. Our primary criterion was that if the investor is domiciled in the same province as that of the entrepreneurial firm, then that province was naturally used as the investor's domicile. The remaining criteria considered all other cases for which the investor and entrepreneur were not domiciled in the same province. For these cases, we developed a ranking of the likelihood of the investor's primary province of residence based on the premise that venture funds with offices in Ontario tend to have their head office in their Ontario, and their satellite offices elsewhere. This is consistent with the organization of most funds in Canada,[45] and the greater number of transactions in Ontario. For venture funds with offices in multiple jurisdictions other than Ontario, we then used Quebec as the primary office (if there was an office in Quebec, but not Ontario), then British Columbia (if there was an office in British Columbia, but not Ontario or Quebec), then Alberta (etc.), Saskatchewan, Manitoba, Nova Scotia, New Brunswick, and Prince Edward Island (none of the venture funds in the data had an office in Newfoundland). This categorization of the primary offices will, to the extent that funds with an office in Ontario do not use Toronto as the primary office, lead to an overstatement in the data of the extent to which Ontario funds are more inclined to invest across provinces. However, the categorization of the primary office location does not materially impact any of the tests of inter- versus intra-provincial investment. As mentioned, if one of the investor's offices is in the same province as that of the entrepreneur, then that office is used and the investment is treated as an intra-provincial investment. As well, it is noteworthy that only 3347 of the 13,729 transactions were derived from firms that had offices in more than one province.

In each table we present a number of models with different right-hand-side variables to illustrate the robustness of the results. We also considered many alternative specifications (available upon request); however, the results were not materially different. Note that the right-hand-side variables do not include "choice" variables, such as staging, syndication and capital structure. Such variables are not exogenous to the decision to invest in a firm resident in a different province (or not). In section 4, we reported comparison of proportion tests to ascertain correlations between certain choice variables and inter- versus intra-provincial investment, but such choice variables are not appropriate for the multivariate tests which have a causal structure.

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45 See http://www.cvca.ca/full_members/index.html.

Appendix B

Supplementary Material

In the following set of tables (Tables A1-A10) we present descriptive statistics on the number of intra- and inter-provincial investments. The descriptive statistics provide breakdowns by type of investor (corporate, government, LSVCC, limited partnership, institutional), type of entrepreneurial firm (industry, publicly traded versus privately held, stage of development for start-up, expansion, buyout and turnaround), and transaction specific factors (staged financing round, syndication, capital structure, year of investment, amount invested by investor, and total amounts invested by all syndicated investors).
In particular, the Tables are as follows:

Table A1	All investors and all entrepreneurial firms
Table A2	All investors and seed and early stage entrepreneurial firms
Table A3	All investors and privately held versus publicly traded entrepreneurial firms
Table A4	All investors and life science, other high tech, and traditional industry (non-high tech) entrepreneurial firms
Table A5	Investor types (corporate, Government, institutional, LSVCC, limited partnership) and all types of entrepreneurial firms
Table A6	All investors and all entrepreneurial firms over different years (1991-1994, 1995-1998, 1999-2000, and 2001-2003)
Table A7	All investors and all entrepreneurial firms for different amounts invested (<\$100,000, \$100,000-\$500,000, \$500,00- \$1,000,000, \$1,000,000-\$5,000,000, and >\$5,000,000)
Table A8	All investors and all entrepreneurial firms for different total deal sizes (<\$100,000, \$100,000-\$500,000, \$500,000-\$1,000,000, \$1,000,000-\$5,000,000, and >\$5,000,000)
Table A9	All investors and all entrepreneurial firms for different securities used (common equity, preferred equity, convertible preferred equity, debt, convertible debt, warrants, mixes of debt and common equity, mixes of preferred equity and common equity, and other combinations)
Table A10	All investors and all entrepreneurial firms for syndicated and non-syndicated investments, as well as different staged financing rounds (round 1, rounds 2-5, rounds 6-10, and rounds 11-15)

Table A1. Are Entrepreneurs and Investors Located in the Same Province?

All types of entrepreneurs and all types of investors over all years, 1991 (Quarter 1) - 2003 (Quarter 1)

This table presents the number of investments by private equity investors (of all types) and by entrepreneurs (of all types at different stages of development and different industries), for each province. The location of the entrepreneur is based on their place of business (or primary place, in a minority of cases where entrepreneurs carried on business in more than 1 province), as recorded by Macdonald and Associates, Ltd. The location of the investor is recorded as follows: if the investor has an office in the same province as the entrepreneur, then only that province is recorded; otherwise, the office in the primary other province of residence is recorded in this table. 13729 observations. 1991 Quarter 1 to 2003 Quarter 1.

		Primary Location of Entrepreneurial Firm											
		BC	AB	SK	MB	ON	QC	NF	NB	NS	PEI	Total	% Investors Financing Entrepreneurs in Same Province
Primary Location of Investor	BC	999	8	0	2	9	3	0	0	0	0	1021	97.85%
	AB	21	156	4	6	16	3	0	0	0	1	207	75.36%
	SK	5	9	146	0	3	0	0	0	0	0	163	89.57%
	MB	11	0	2	315	13	1	0	2	1	0	345	91.30%
	ON	247	200	39	40	3530	287	14	42	56	8	4463	79.09%
	QC	55	44	0	9	222	4962	2	9	2	0	5305	93.53%
	NF	0	0	0	0	0	0	0	0	0	0	0	NA
	NB	0	0	0	0	1	1	0	18	0	0	20	90.00%
	NS	2	1	0	0	7	0	13	10	101	0	134	75.37%
	PEI	0	0	0	0	0	0	0	0	0	5	5	100.00%
	Foreign	113	19	0	1	259	62	0	3	1	0	458	NA
	Unknown	280	96	35	29	586	534	12	13	19	4	1608	NA
	Total	1733	533	226	402	4646	5853	41	97	180	18	13729	
% Entrepreneurs Financed by Investors in Same Province, Including Foreign, Excluding Unknown		68.75%	35.70%	76.44%	84.45%	86.95%	93.29%	0.00%	21.43%	62.73%	35.71%		84.42%

Table A2. Are Entrepreneurs and Investors Located in the Same Province?

Panel A. Seed and early stage entrepreneurs and all types of investors over all years, 1991 (Quarter 1) - 2003 (Quarter 1)

This table presents the number of investments by private equity investors (of all types) and by entrepreneurs (of seed and early stage of development only), for each province. The location of the entrepreneur is based on their place of business (or primary place, in a minority of cases where entrepreneurs carried on business in more than 1 province), as recorded by Macdonald and Associates, Ltd. The location of the investor is recorded as follows: if the investor has an office in the same province as the entrepreneur, then only that province is recorded; otherwise, the office in the primary other province of residence is recorded in this table. 13729 observations. 1991 Quarter 1 to 2003 Quarter 1.

		Primary Location of Entrepreneurial Firm											% Investors Financing Entrepreneurs in Same Province
		BC	AB	SK	MB	ON	QC	NF	NB	NS	PEI	Total	
Primary Location of Investor	BC	547	8	0	1	5	2	0	0	0	0	563	97.16%
	AB	11	66	3	3	7	0	0	0	0	0	90	73.33%
	SK	4	3	71	0	1	0	0	0	0	0	79	89.87%
	MB	3	0	0	157	6	0	0	0	1	0	167	94.01%
	ON	140	101	15	10	1709	149	8	17	27	5	2181	78.36%
	QC	26	27	0	7	103	2319	0	0	1	0	2483	93.40%
	NF	0	0	0	0	0	0	0	0	0	0	0	NA
	NB	0	0	0	0	1	1	0	10	0	0	12	83.33%
	NS	2	0	0	0	3	0	11	4	85	0	105	80.95%
	PEI	0	0	0	0	0	0	0	0	0	3	3	100.00%
	Foreign	71	14	0	1	142	38	0	2	0	0	268	NA
	Unknown	138	49	22	12	293	288	8	4	10	3	827	NA
	Total	942	268	111	191	2270	2797	27	37	124	11	6778	
% Entrepreneurs Financed by Investors in Same Province, Including Foreign, Excluding Unknown		68.03%	30.14%	79.78%	87.71%	86.44%	92.43%	0.00%	30.30%	74.56%	37.50%		83.46%

Table A2. Are Entrepreneurs and Investors Located in the Same Province?

Panel B. Expansion stage entrepreneurs and all types of investors over all years, 1991 (Quarter 1) - 2003 (Quarter 1)

This table presents the number of investments by private equity investors (of all types) and by entrepreneurs (of expansion stage of development only), for each province. The location of the entrepreneur is based on their place of business (or primary place, in a minority of cases where entrepreneurs carried on business in more than 1 province), as recorded by Macdonald and Associates, Ltd. The location of the investor is recorded as follows: if the investor has an office in the same province as the entrepreneur, then only that province is recorded; otherwise, the office in the primary other province of residence is recorded in this table. 13729 observations. 1991 Quarter 1 to 2003 Quarter 1.

		Primary Location of Entrepreneurial Firm											
		BC	AB	SK	MB	ON	QC	NF	NB	NS	PEI	Total	% Investors Financing Entrepreneurs in Same Province
Primary Location of Investor	BC	384	0	0	1	4	1	0	0	0	0	390	98.46%
	AB	7	63	1	2	7	3	0	0	0	0	83	75.90%
	SK	1	5	60	0	2	0	0	0	0	0	68	88.24%
	MB	7	0	0	133	7	1	0	2	0	0	150	88.67%
	ON	91	73	12	20	1491	102	5	19	23	1	1837	81.16%
	QC	29	15	0	2	108	1790	2	9	1	0	1956	91.51%
	NF	0	0	0	0	0	0	0	0	0	0	0	NA
	NB	0	0	0	0	0	0	0	8	0	0	8	100.00%
	NS	0	1	0	0	4	0	2	6	14	0	27	51.85%
	PEI	0	0	0	0	0	0	0	0	0	1	1	100.00%
	Foreign	38	5	0	0	110	22	0	1	1	0	177	NA
	Unknown	130	28	8	11	245	176	3	9	6	0	616	NA
	Total	687	190	81	169	1978	2095	12	54	45	2	5313	
% Entrepreneurs Financed by Investors in Same Province, Including Foreign, Excluding Unknown		68.94%	38.89%	82.19%	84.18%	86.04%	93.28%	0.00%	17.78%	35.90%	50.00%		83.97%

Table A2. Are Entrepreneurs and Investors Located in the Same Province?

Panel C. Buyout stage entrepreneurs and all types of investors over all years, 1991 (Quarter 1) - 2003 (Quarter 1)

This table presents the number of investments by private equity investors (of all types) and by entrepreneurs (of buyout stage of development only), for each province. The location of the entrepreneur is based on their place of business (or primary place, in a minority of cases where entrepreneurs carried on business in more than 1 province), as recorded by Macdonald and Associates, Ltd. The location of the investor is recorded as follows: if the investor has an office in the same province as the entrepreneur, then only that province is recorded; otherwise, the office in the primary other province of residence is recorded in this table. 13729 observations. 1991 Quarter 1 to 2003 Quarter 1.

		Primary Location of Entrepreneurial Firm											% Investors Financing Entrepreneurs in Same Province
		BC	AB	SK	MB	ON	QC	NF	NB	NS	PEI	Total	
Primary Location of Investor	BC	19	0	0	0	0	0	0	0	0	0	19	100.00%
	AB	2	19	0	0	0	0	0	0	0	1	22	86.36%
	SK	0	1	13	0	0	0	0	0	0	0	14	92.86%
	MB	1	0	1	8	0	0	0	0	0	0	10	80.00%
	ON	6	9	9	6	137	12	0	6	4	2	191	71.73%
	QC	0	0	0	0	5	213	0	0	0	0	218	97.71%
	NF	0	0	0	0	0	0	0	0	0	0	0	NA
	NB	0	0	0	0	0	0	0	0	0	0	0	NA
	NS	0	0	0	0	0	0	0	0	0	0	0	NA
	PEI	0	0	0	0	0	0	0	0	0	1	1	100.00%
	Foreign	1	0	0	0	5	1	0	0	0	0	7	NA
	Unknown	6	9	5	4	25	26	0	0	1	1	77	NA
	Total	35	38	28	18	172	252	0	6	5	5	559	
% Entrepreneurs Financed by Investors in Same Province, Including Foreign, Excluding Unknown		65.52%	65.52%	56.52%	57.14%	93.20%	94.25%	NA	0.00%	0.00%	25.00%		85.06%

Table A2. Are Entrepreneurs and Investors Located in the Same Province?

Panel D. Turnaround stage entrepreneurs and all types of investors over all years, 1991 (Quarter 1) - 2003 (Quarter 1)

This table presents the number of investments by private equity investors (of all types) and by entrepreneurs (of turnaround stage of development only), for each province. The location of the entrepreneur is based on their place of business (or primary place, in a minority of cases where entrepreneurs carried on business in more than 1 province), as recorded by Macdonald and Associates, Ltd. The location of the investor is recorded as follows: if the investor has an office in the same province as the entrepreneur, then only that province is recorded; otherwise, the office in the primary other province of residence is recorded in this table. 13729 observations. 1991 Quarter 1 to 2003 Quarter 1.

		Primary Location of Entrepreneurial Firm											
		BC	AB	SK	MB	ON	QC	NF	NB	NS	PEI	Total	% Investors Financing Entrepreneurs in Same Province
Primary Location of Investor	BC	19	0	0	0	0	0	0	0	0	0	19	100.00%
	AB	0	1	0	0	0	0	0	0	0	0	1	100.00%
	SK	0	0	1	0	0	0	0	0	0	0	1	100.00%
	MB	0	0	0	9	0	0	0	0	0	0	9	100.00%
	ON	3	3	1	1	95	5	1	0	0	0	109	87.16%
	QC	0	0	0	0	2	528	0	0	0	0	530	99.62%
	NF	0	0	0	0	0	0	0	0	0	0	0	NA
	NB	0	0	0	0	0	0	0	0	0	0	0	NA
	NS	0	0	0	0	0	0	0	0	1	0	1	100.00%
	PEI	0	0	0	0	0	0	0	0	0	0	0	NA
	Foreign	0	0	0	0	1	1	0	0	0	0	2	NA
	Unknown	4	2	0	2	16	36	1	0	1	0	62	NA
	Total	26	6	2	12	114	570	2	0	2	0	734	
% Entrepreneurs Financed by Investors in Same Province, Including Foreign, Excluding Unknown		86.36%	25.00%	50.00%	90.00%	96.94%	98.88%	0.00%	NA	100.00%	NA		97.32%

Table A3. Are Entrepreneurs and Investors Located in the Same Province?

Panel A. All types of privately held entrepreneurs (without a stock exchange listing) and all types of investors over all years, 1991 (Quarter 1) - 2003 (Quarter 1)

This table presents the number of investments by private equity investors (of all types) and by entrepreneurs (without a stock exchange listing only), for each province. The location of the entrepreneur is based on their place of business (or primary place, in a minority of cases where entrepreneurs carried on business in more than 1 province), as recorded by Macdonald and Associates, Ltd. The location of the investor is recorded as follows: if the investor has an office in the same province as the entrepreneur, then only that province is recorded; otherwise, the office in the primary other province of residence is recorded in this table. 13729 observations. 1991 Quarter 1 to 2003 Quarter 1.

		Primary Location of Entrepreneurial Firm											% Investors Financing Entrepreneurs in Same Province
		BC	AB	SK	MB	ON	QC	NF	NB	NS	PEI	Total	
Primary Location of Investor	BC	765	8	0	2	6	3	0	0	0	0	784	97.58%
	AB	18	126	4	6	11	0	0	0	0	1	166	75.90%
	SK	5	6	129	0	2	0	0	0	0	0	142	90.85%
	MB	9	0	2	278	9	1	0	0	1	0	300	92.67%
	ON	195	149	35	39	2878	228	11	39	56	6	3636	79.15%
	QC	33	27	0	9	196	4450	2	9	2	0	4728	94.12%
	NF	0	0	0	0	0	0	0	0	0	0	0	NA
	NB	0	0	0	0	1	1	0	18	0	0	20	90.00%
	NS	0	0	0	0	3	0	13	10	99	0	125	79.20%
	PEI	0	0	0	0	0	0	0	0	0	5	5	100.00%
	Foreign	102	11	0	1	252	61	0	3	1	0	431	NA
	Unknown	224	83	34	28	491	489	9	10	19	2	1389	NA
	Total	1351	410	204	363	3849	5233	35	89	178	14	11726	
% Entrepreneurs Financed by Investors in Same Province, Including Foreign, Excluding Unknown		67.88%	38.53%	75.88%	82.99%	85.71%	93.80%	0.00%	22.78%	62.26%	41.67%		84.63%

Table A3. Are Entrepreneurs and Investors Located in the Same Province?

Panel B. All types of publicly traded entrepreneurs (with a stock exchange listing) and all types of investors over all years, 1991 (Quarter 1) - 2003 (Quarter 1)

This table presents the number of investments by private equity investors (of all types) and by entrepreneurs (with a stock exchange listing only), for each province. The location of the entrepreneur is based on their place of business (or primary place, in a minority of cases where entrepreneurs carried on business in more than 1 province), as recorded by Macdonald and Associates, Ltd. The location of the investor is recorded as follows: if the investor has an office in the same province as the entrepreneur, then only that province is recorded; otherwise, the office in the primary other province of residence is recorded in this table. 13729 observations. 1991 Quarter 1 to 2003 Quarter 1.

		Primary Location of Entrepreneurial Firm											% Investors Financing Entrepreneurs in Same Province
		BC	AB	SK	MB	ON	QC	NF	NB	NS	PEI	Total	
Primary Location of Investor	BC	234	0	0	0	3	0	0	0	0	0	237	98.73%
	AB	3	30	0	0	5	3	0	0	0	0	41	73.17%
	SK	0	3	17	0	1	0	0	0	0	0	21	80.95%
	MB	2	0	0	37	4	0	0	2	0	0	45	82.22%
	ON	52	51	4	1	652	59	3	3	0	2	827	78.84%
	QC	22	17	0	0	26	512	0	0	0	0	577	88.73%
	NF	0	0	0	0	0	0	0	0	0	0	0	NA
	NB	0	0	0	0	0	0	0	0	0	0	0	NA
	NS	2	1	0	0	4	0	0	0	2	0	9	22.22%
	PEI	0	0	0	0	0	0	0	0	0	0	0	NA
	Foreign	11	8	0	0	7	1	0	0	0	0	27	NA
	Unknown	56	13	1	1	95	45	3	3	0	2	219	NA
	Total	382	123	22	39	797	620	6	8	2	4	2003	
% Entrepreneurs Financed by Investors in Same Province, Including Foreign, Excluding Unknown		71.78%	27.27%	80.95%	97.37%	92.88%	89.04%	0.00%	0.00%	100.00%	0.00%		83.18%

Table A4. Are Entrepreneurs and Investors Located in the Same Province?

Panel A. Life Science entrepreneurs and all types of investors over all years, 1991 (Quarter 1) - 2003 (Quarter 1)

This table presents the number of investments by private equity investors (of all types) and by entrepreneurs (in the Life Science industries only), for each province. The location of the entrepreneur is based on their place of business (or primary place, in a minority of cases where entrepreneurs carried on business in more than 1 province), as recorded by Macdonald and Associates, Ltd. The location of the investor is recorded as follows: if the investor has an office in the same province as the entrepreneur, then only that province is recorded; otherwise, the office in the primary other province of residence is recorded in this table. 13729 observations. 1991 Quarter 1 to 2003 Quarter 1.

		Primary Location of Entrepreneurial Firm											% Investors Financing Entrepreneurs in Same Province
		BC	AB	SK	MB	ON	QC	NF	NB	NS	PEI	Total	
Primary Location of Investor	BC	325	5	0	1	3	1	0	0	0	0	335	97.01%
	AB	2	14	3	0	1	0	0	0	0	0	20	70.00%
	SK	0	0	37	0	2	0	0	0	0	0	39	94.87%
	MB	3	0	0	71	1	1	0	0	0	0	76	93.42%
	ON	90	40	23	8	546	117	0	9	12	1	846	64.54%
	QC	29	11	0	1	53	1056	0	7	1	0	1158	91.19%
	NF	0	0	0	0	0	0	0	0	0	0	0	NA
	NB	0	0	0	0	0	0	0	2	0	0	2	100.00%
	NS	0	0	0	0	0	0	0	5	31	0	36	86.11%
	PEI	0	0	0	0	0	0	0	0	0	0	0	NA
	Foreign	17	3	0	1	10	16	0	1	0	0	48	NA
	Unknown	66	15	7	6	60	107	0	4	5	0	270	NA
	Total	532	88	70	88	676	1298	0	28	49	1	2830	
% Entrepreneurs Financed by Investors in Same Province, Including Foreign, Excluding Unknown		69.74%	19.18%	58.73%	86.59%	88.64%	88.66%	NA	8.33%	70.45%	0.00%		81.33%

Table A4. Are Entrepreneurs and Investors Located in the Same Province?

Panel B. High Tech (excluding Life Science Industries) entrepreneurs and all types of investors over all years, 1991 (Quarter 1) - 2003 (Quarter 1)

This table presents the number of investments by private equity investors (of all types) and by entrepreneurs (in the High Tech industries (excluding Life Science Industries) only), for each province. The location of the entrepreneur is based on their place of business (or primary place, in a minority of cases where entrepreneurs carried on business in more than 1 province), as recorded by Macdonald and Associates, Ltd. The location of the investor is recorded as follows: if the investor has an office in the same province as the entrepreneur, then only that province is recorded; otherwise, the office in the primary other province of residence is recorded in this table. 13729 observations. 1991 Quarter 1 to 2003 Quarter 1.

		Primary Location of Entrepreneurial Firm											% Investors Financing Entrepreneurs in Same Province
		BC	AB	SK	MB	ON	QC	NF	NB	NS	PEI	Total	
Primary Location of Investor	BC	445	2	0	0	6	2	0	0	0	0	455	97.80%
	AB	8	63	1	0	10	3	0	0	0	1	86	73.26%
	SK	4	0	22	0	0	0	0	0	0	0	26	84.62%
	MB	6	0	0	50	11	0	0	2	1	0	70	71.43%
	ON	103	78	4	5	2115	115	10	22	36	5	2493	84.84%
	QC	2	3	0	3	130	1790	2	1	0	0	1931	92.70%
	NF	0	0	0	0	0	0	0	0	0	0	0	NA
	NB	0	0	0	0	1	0	0	4	0	0	5	80.00%
	NS	2	0	0	0	7	0	7	5	55	0	76	72.37%
	PEI	0	0	0	0	0	0	0	0	0	0	0	NA
	Foreign	70	15	0	0	243	44	0	2	1	0	375	NA
	Unknown	146	41	1	5	400	238	4	8	6	2	851	NA
	Total	786	202	28	63	2923	2192	23	44	99	8	6368	
% Entrepreneurs Financed by Investors in Same Province, Including Foreign, Excluding Unknown		69.53%	39.13%	81.48%	86.21%	83.83%	91.61%	0.00%	11.11%	59.14%	0.00%		82.36%

Table A4. Are Entrepreneurs and Investors Located in the Same Province?

Panel C. Entrepreneurs in Traditional Industries and all types of investors over all years, 1991 (Quarter 1) - 2003 (Quarter 1)

This table presents the number of investments by private equity investors (of all types) and by entrepreneurs (in Traditional industries only -- i.e., not High Tech or Life Sciences), for each province. The location of the entrepreneur is based on their place of business (or primary place, in a minority of cases where entrepreneurs carried on business in more than 1 province), as recorded by Macdonald and Associates, Ltd. The location of the investor is recorded as follows: if the investor has an office in the same province as the entrepreneur, then only that province is recorded; otherwise, the office in the primary other province of residence is recorded in this table. 13729 observations. 1991 Quarter 1 to 2003 Quarter 1.

		Primary Location of Entrepreneurial Firm											
		BC	AB	SK	MB	ON	QC	NF	NB	NS	PEI	Total	% Investors Financing Entrepreneurs in Same Province
Primary Location of Investor	BC	229	1	0	1	0	0	0	0	0	0	231	99.13%
	AB	11	79	0	6	5	0	0	0	0	0	101	78.22%
	SK	1	9	87	0	1	0	0	0	0	0	98	88.78%
	MB	2	0	2	194	1	0	0	0	0	0	199	97.49%
	ON	54	82	12	27	869	55	4	11	8	2	1124	77.31%
	QC	24	30	0	5	39	2116	0	1	1	0	2216	95.49%
	NF	0	0	0	0	0	0	0	0	0	0	0	NA
	NB	0	0	0	0	0	1	0	12	0	0	13	92.31%
	NS	0	1	0	0	0	0	6	0	15	0	22	68.18%
	PEI	0	0	0	0	0	0	0	0	0	5	5	100.00%
	Foreign	26	1	0	0	6	2	0	0	0	0	35	NA
	Unknown	68	40	27	18	126	189	8	1	8	2	487	NA
	Total	415	243	128	251	1047	2363	18	25	32	9	4531	
% Entrepreneurs Financed by Investors in Same Province, Including Foreign, Excluding Unknown		65.99%	38.92%	86.14%	83.26%	94.35%	97.33%	0.00%	50.00%	62.50%	71.43%		89.17%

Table A5. Are Entrepreneurs and Investors Located in the Same Province?

Panel A. All types of entrepreneurs and all Corporate investors (only) over all years, 1991 (Quarter 1) - 2003 (Quarter 1)

This table presents the number of investments by private equity investors (corporate only) and by entrepreneurs (of all types), for each province. The location of the entrepreneur is based on their place of business (or primary place, in a minority of cases where entrepreneurs carried on business in more than 1 province), as recorded by Macdonald and Associates, Ltd. The location of the investor is recorded as follows: if the investor has an office in the same province as the entrepreneur, then only that province is recorded; otherwise, the office in the primary other province of residence is recorded in this table. 13729 observations. 1991 Quarter 1 to 2003 Quarter 1.

		Primary Location of Entrepreneurial Firm											
		BC	AB	SK	MB	ON	QC	NF	NB	NS	PEI	Total	% Investors Financing Entrepreneurs in Same Province
Primary Location of Investor	BC	130	0	0	0	3	1	0	0	0	0	134	97.01%
	AB	0	23	0	0	1	3	0	0	0	0	27	85.19%
	SK	0	0	0	0	0	0	0	0	0	0	0	NA
	MB	2	0	0	0	1	0	0	0	0	0	3	0.00%
	ON	35	38	11	14	422	22	5	6	7	0	560	75.36%
	QC	10	0	0	0	23	422	0	0	0	0	455	92.75%
	NF	0	0	0	0	0	0	0	0	0	0	0	NA
	NB	0	0	0	0	0	1	0	10	0	0	11	90.91%
	NS	0	1	0	0	1	0	1	0	7	0	10	70.00%
	PEI	0	0	0	0	0	0	0	0	0	0	0	NA
	Foreign	6	0	0	1	4	8	0	0	0	0	19	NA
	Unknown	20	4	0	2	22	4	0	1	0	0	53	NA
	Total	203	66	11	17	477	461	6	17	14	0	1272	
% Entrepreneurs Financed by Investors in Same Province, Including Foreign, Excluding Unknown		71.04%	37.10%	0.00%	0.00%	92.75%	92.34%	0.00%	62.50%	50.00%	NA		83.18%

Table A5. Are Entrepreneurs and Investors Located in the Same Province?

Panel B. All types of entrepreneurs and all Government investors (only) over all years, 1991 (Quarter 1) - 2003 (Quarter 1)

This table presents the number of investments by private equity investors (Government only) and by entrepreneurs (all types), for each province. The location of the entrepreneur is based on their place of business (or primary place, in a minority of cases where entrepreneurs carried on business in more than 1 province), as recorded by Macdonald and Associates, Ltd. The location of the investor is recorded as follows: if the investor has an office in the same province as the entrepreneur, then only that province is recorded; otherwise, the office in the primary other province of residence is recorded in this table. 13729 observations. 1991 Quarter 1 to 2003 Quarter 1.

		Primary Location of Entrepreneurial Firm											
		BC	AB	SK	MB	ON	QC	NF	NB	NS	PEI	Total	% Investors Financing Entrepreneurs in Same Province
Primary Location of Investor	BC	119	0	0	0	0	0	0	0	0	0	119	100.00%
	AB	0	21	0	0	0	0	0	0	0	0	21	100.00%
	SK	5	2	74	0	2	0	0	0	0	0	83	89.16%
	MB	0	0	0	4	0	0	0	0	0	0	4	100.00%
	ON	3	3	8	0	341	4	2	11	0	2	374	91.18%
	QC	2	1	0	0	9	1121	0	0	0	0	1133	98.94%
	NF	0	0	0	0	0	0	0	0	0	0	0	NA
	NB	0	0	0	0	0	0	0	0	0	0	0	NA
	NS	0	0	0	0	5	0	0	0	42	0	47	89.36%
	PEI	0	0	0	0	0	0	0	0	0	0	0	NA
	Foreign	1	0	0	0	0	1	0	0	0	0	2	NA
	Unknown	14	25	0	0	0	2	0	0	0	0	41	NA
	Total	144	52	82	4	357	1128	2	11	42	2	1824	
% Entrepreneurs Financed by Investors in Same Province, Including Foreign, Excluding Unknown		91.54%	77.78%	90.24%	100.00%	95.52%	99.56%	0.00%	0.00%	100.00%	0.00%		96.58%

Table A5. Are Entrepreneurs and Investors Located in the Same Province?

Panel C. All types of entrepreneurs and Institutional investors (only) over all years, 1991 (Quarter 1) - 2003 (Quarter 1)

This table presents the number of investments by private equity investors (Institutional, only) and by entrepreneurs (of all types), for each province. The location of the entrepreneur is based on their place of business (or primary place, in a minority of cases where entrepreneurs carried on business in more than 1 province), as recorded by Macdonald and Associates, Ltd. The location of the investor is recorded as follows: if the investor has an office in the same province as the entrepreneur, then only that province is recorded; otherwise, the office in the primary other province of residence is recorded in this table. 13729 observations. 1991 Quarter 1 to 2003 Quarter 1.

		Primary Location of Entrepreneurial Firm											
		BC	AB	SK	MB	ON	QC	NF	NB	NS	PEI	Total	% Investors Financing Entrepreneurs in Same Province
Primary Location of Investor	BC	6	0	0	0	0	0	0	0	0	0	6	100.00%
	AB	0	0	0	0	0	0	0	0	0	0	0	NA
	SK	0	0	4	0	0	0	0	0	0	0	4	100.00%
	MB	0	0	0	2	0	0	0	0	0	0	2	100.00%
	ON	10	7	0	0	56	14	0	1	0	0	88	63.64%
	QC	11	11	0	3	89	1076	2	9	1	0	1202	89.52%
	NF	0	0	0	0	0	0	0	0	0	0	0	NA
	NB	0	0	0	0	0	0	0	0	0	0	0	NA
	NS	0	0	0	0	0	0	0	0	0	0	0	NA
	PEI	0	0	0	0	0	0	0	0	0	0	0	NA
	Foreign	2	1	0	0	1	0	0	2	0	0	6	NA
	Unknown	21	8	1	2	70	42	0	1	2	1	148	NA
	Total	50	27	5	7	216	1132	2	13	3	1	1456	
% Entrepreneurs Financed by Investors in Same Province, Including Foreign, Excluding Unknown		20.69%	0.00%	100.00%	40.00%	38.36%	98.72%	0.00%	0.00%	0.00%	NA		87.46%

Table A5. Are Entrepreneurs and Investors Located in the Same Province?

Panel D. All types of entrepreneurs and LSVCC investors (only) over all years, 1991 (Quarter 1) - 2003 (Quarter 1)

This table presents the number of investments by private equity investors (LSVCCs only) and by entrepreneurs (all types), for each province. The location of the entrepreneur is based on their place of business (or primary place, in a minority of cases where entrepreneurs carried on business in more than 1 province), as recorded by Macdonald and Associates, Ltd. The location of the investor is recorded as follows: if the investor has an office in the same province as the entrepreneur, then only that province is recorded; otherwise, the office in the primary other province of residence is recorded in this table. 13729 observations. 1991 Quarter 1 to 2003 Quarter 1.

		Primary Location of Entrepreneurial Firm											% Investors Financing Entrepreneurs in Same Province
		BC	AB	SK	MB	ON	QC	NF	NB	NS	PEI	Total	
Primary Location of Investor	BC	294	0	0	0	0	0	0	0	0	0	294	100.00%
	AB	0	0	0	0	0	0	0	0	0	0	0	NA
	SK	0	7	59	0	1	0	0	0	0	0	67	88.06%
	MB	9	0	2	228	3	0	0	0	0	0	242	94.21%
	ON	72	59	5	16	1404	79	1	12	7	4	1659	84.63%
	QC	0	1	0	0	11	1403	0	0	0	0	1415	99.15%
	NF	0	0	0	0	0	0	0	0	0	0	0	NA
	NB	0	0	0	0	0	0	0	7	0	0	7	100.00%
	NS	0	0	0	0	0	0	0	0	9	0	9	100.00%
	PEI	0	0	0	0	0	0	0	0	0	0	0	NA
	Foreign	0	0	0	0	0	0	0	0	0	0	0	NA
	Unknown	0	0	0	0	0	0	0	0	0	0	0	NA
	Total	375	67	66	244	1419	1482	1	19	16	4	3693	
% Entrepreneurs Financed by Investors in Same Province, Including Foreign, Excluding Unknown		78.40%	0.00%	89.39%	93.44%	98.94%	94.67%	0.00%	36.84%	56.25%	0.00%		92.17%

Table A5. Are Entrepreneurs and Investors Located in the Same Province?

Panel E. All types of entrepreneurs and Private Independent investors (only) over all years, 1991 (Quarter 1) - 2003 (Quarter 1)

This table presents the number of investments by private equity investors (private independent only) and by entrepreneurs (all types), for each province. The location of the entrepreneur is based on their place of business (or primary place, in a minority of cases where entrepreneurs carried on business in more than 1 province), as recorded by Macdonald and Associates, Ltd. The location of the investor is recorded as follows: if the investor has an office in the same province as the entrepreneur, then only that province is recorded; otherwise, the office in the primary other province of residence is recorded in this table. 13729 observations. 1991 Quarter 1 to 2003 Quarter 1.

		Primary Location of Entrepreneurial Firm											
		BC	AB	SK	MB	ON	QC	NF	NB	NS	PEI	Total	% Investors Financing Entrepreneurs in Same Province
Primary Location of Investor	BC	419	8	0	0	5	1	0	0	0	0	433	96.77%
	AB	21	104	4	6	14	0	0	0	0	1	150	69.33%
	SK	0	0	7	0	0	0	0	0	0	0	7	100.00%
	MB	0	0	0	77	9	0	0	2	1	0	89	86.52%
	ON	86	92	15	9	1171	105	6	12	41	2	1539	76.09%
	QC	29	31	0	6	85	927	0	0	1	0	1079	85.91%
	NF	0	0	0	0	0	0	0	0	0	0	0	NA
	NB	0	0	0	0	0	0	0	0	0	0	0	NA
	NS	2	0	0	0	1	0	12	10	43	0	68	63.24%
	PEI	0	0	0	0	0	0	0	0	0	5	5	100.00%
	Foreign	0	0	0	0	3	4	0	0	0	0	7	NA
	Unknown	2	2	0	0	15	6	0	1	0	0	26	NA
	Total	559	237	26	98	1303	1043	18	25	86	8	3403	
% Entrepreneurs Financed by Investors in Same Province, Including Foreign, Excluding Unknown		75.22%	44.26%	26.92%	78.57%	90.92%	89.39%	0.00%	0.00%	50.00%	62.50%		81.52%

Table A6. Are Entrepreneurs and Investors Located in the Same Province?

Panel A. All types of entrepreneurs and all types of investors over all years, 1991 (Quarter 1) - 1994 (Quarter 4)

This table presents the number of investments by private equity investors (of all types) and by entrepreneurs (of all types at different stages of development and different industries), for each province. The location of the entrepreneur is based on their place of business (or primary place, in a minority of cases where entrepreneurs carried on business in more than 1 province), as recorded by Macdonald and Associates, Ltd. The location of the investor is recorded as follows: if the investor has an office in the same province as the entrepreneur, then only that province is recorded; otherwise, the office in the primary other province of residence is recorded in this table. 1991 Quarter 1 to 1994 Quarter 4.

		Primary Location of Entrepreneurial Firm											
		BC	**AB**	**SK**	**MB**	**ON**	**QC**	**NF**	**NB**	**NS**	**PEI**	**Total**	**% Investors Financing Entrepreneurs in Same Province**
Primary Location of Investor	**BC**	82	0	0	0	4	0	0	0	0	0	86	95.35%
	AB	5	46	2	2	0	0	0	0	0	0	55	83.64%
	SK	0	0	11	0	0	0	0	0	0	0	11	100.00%
	MB	0	0	0	17	1	0	0	0	0	0	18	94.44%
	ON	24	13	2	4	380	35	0	3	1	1	463	82.07%
	QC	0	4	0	0	14	426	0	0	0	0	444	95.95%
	NF	0	0	0	0	0	0	0	0	0	0	0	NA
	NB	0	0	0	0	0	0	0	0	0	0	0	NA
	NS	0	0	0	0	0	0	0	0	0	0	0	NA
	PEI	0	0	0	0	0	0	0	0	0	0	0	NA
	Foreign	4	0	0	0	4	0	0	0	0	0	8	NA
	Unknown	16	32	0	2	26	35	0	0	0	0	111	NA
	Total	131	95	15	25	429	496	0	3	1	1	1196	
% Entrepreneurs Financed by Investors in Same Province, Including Foreign, Excluding Unknown		71.30%	73.02%	73.33%	73.91%	94.29%	92.41%	NA	0.00%	0.00%	0.00%		88.66%

Table A6. Are Entrepreneurs and Investors Located in the Same Province?

Panel B. All types of entrepreneurs and all types of investors over all years, 1995 (Quarter 1) - 1998 (Quarter 4)

This table presents the number of investments by private equity investors (of all types) and by entrepreneurs (of all types at different stages of development and different industries), for each province. The location of the entrepreneur is based on their place of business (or primary place, in a minority of cases where entrepreneurs carried on business in more than 1 province), as recorded by Macdonald and Associates, Ltd. The location of the investor is recorded as follows: if the investor has an office in the same province as the entrepreneur, then only that province is recorded; otherwise, the office in the primary other province of residence is recorded in this table. 1995 Quarter 1 to 1998 Quarter 4.

		Primary Location of Entrepreneurial Firm											
		BC	AB	SK	MB	ON	QC	NF	NB	NS	PEI	Total	% Investors Financing Entrepreneurs in Same Province
Primary Location of Investor	BC	288	0	0	0	0	0	0	0	0	0	288	100.00%
	AB	4	40	0	4	0	0	0	0	0	0	48	83.33%
	SK	1	1	58	0	0	0	0	0	0	0	60	96.67%
	MB	0	0	0	58	2	0	0	0	1	0	61	95.08%
	ON	77	74	20	20	1131	112	6	12	16	4	1472	76.83%
	QC	15	12	0	3	57	1621	2	1	1	0	1712	94.68%
	NF	0	0	0	0	0	0	0	0	0	0	0	NA
	NB	0	0	0	0	0	1	0	8	0	0	9	88.89%
	NS	0	0	0	0	1	0	3	2	37	0	43	86.05%
	PEI	0	0	0	0	0	0	0	0	0	2	2	100.00%
	Foreign	35	1	0	0	5	6	0	0	0	0	47	NA
	Unknown	75	14	18	11	129	123	3	2	8	0	383	NA
	Total	495	142	96	96	1325	1863	14	25	63	6	4125	
% Entrepreneurs Financed by Investors in Same Province, Including Foreign, Excluding Unknown		68.57%	31.25%	74.36%	68.24%	94.57%	93.16%	0.00%	34.78%	67.27%	33.33%		86.66%

Table A6. Are Entrepreneurs and Investors Located in the Same Province?

Panel C. All types of entrepreneurs and all types of investors over all years, 1999 (Quarter 1) - 2000 (Quarter 4)

This table presents the number of investments by private equity investors (of all types) and by entrepreneurs (of all types at different stages of development and different industries), for each province. The location of the entrepreneur is based on their place of business (or primary place, in a minority of cases where entrepreneurs carried on business in more than 1 province), as recorded by Macdonald and Associates, Ltd. The location of the investor is recorded as follows: if the investor has an office in the same province as the entrepreneur, then only that province is recorded; otherwise, the office in the primary other province of residence is recorded in this table. 1999 Quarter 1 to 2000 Quarter 4.

		Primary Location of Entrepreneurial Firm											
		BC	AB	SK	MB	ON	QC	NF	NB	NS	PEI	Total	% Investors Financing Entrepreneurs in Same Province
Primary Location of Investor	BC	300	1	0	1	1	1	0	0	0	0	304	98.68%
	AB	2	41	2	0	6	1	0	0	0	1	53	77.36%
	SK	3	4	32	0	2	0	0	0	0	0	41	78.05%
	MB	4	0	0	96	8	0	0	2	0	0	110	87.27%
	ON	76	66	15	12	1070	83	1	13	22	3	1361	78.62%
	QC	22	18	0	5	78	1443	0	2	1	0	1569	91.97%
	NF	0	0	0	0	0	0	0	0	0	0	0	NA
	NB	0	0	0	0	0	0	0	2	0	0	2	100.00%
	NS	2	1	0	0	1	0	3	4	29	0	40	72.50%
	PEI	0	0	0	0	0	0	0	0	0	3	3	100.00%
	Foreign	20	6	0	0	86	20	0	0	0	0	132	NA
	Unknown	78	27	7	8	247	172	3	7	8	3	560	NA
	Total	507	164	56	122	1499	1720	7	30	60	10	4175	
% Entrepreneurs Financed by Investors in Same Province, Including Foreign, Excluding Unknown		69.93%	29.93%	65.31%	84.21%	85.46%	93.22%	0.00%	8.70%	55.77%	42.86%		83.43%

Table A6. Are Entrepreneurs and Investors Located in the Same Province?

Panel D. All types of entrepreneurs and all types of investors over all years, 2001 (Quarter 1) - 2003 (Quarter 1)

This table presents the number of investments by private equity investors (of all types) and by entrepreneurs (of all types at different stages of development and different industries), for each province. The location of the entrepreneur is based on their place of business (or primary place, in a minority of cases where entrepreneurs carried on business in more than 1 province), as recorded by Macdonald and Associates, Ltd. The location of the investor is recorded as follows: if the investor has an office in the same province as the entrepreneur, then only that province is recorded; otherwise, the office in the primary other province of residence is recorded in this table. 2001 Quarter 1 to 2003 Quarter 1.

		Primary Location of Entrepreneurial Firm											
		BC	AB	SK	MB	ON	QC	NF	NB	NS	PEI	Total	% Investors Financing Entrepreneurs in Same Province
Primary Location of Investor	BC	23	0	0	0	3	1	0	0	0	0	27	85.19%
	AB	0	4	0	0	1	2	0	0	0	0	7	57.14%
	SK	0	0	0	0	0	0	0	0	0	0	0	NA
	MB	1	0	0	0	1	0	0	0	0	0	2	0.00%
	ON	7	6	0	1	120	5	2	0	6	0	147	81.63%
	QC	5	0	0	0	19	193	0	0	0	0	217	88.94%
	NF	0	0	0	0	0	0	0	0	0	0	0	NA
	NB	0	0	0	0	0	0	0	1	0	0	1	100.00%
	NS	0	0	0	0	1	0	0	0	1	0	2	50.00%
	PEI	0	0	0	0	0	0	0	0	0	0	0	NA
	Foreign	3	0	0	1	0	6	0	0	0	0	10	NA
	Unknown	10	0	0	1	6	1	0	0	0	0	18	NA
	Total	49	10	0	3	151	208	2	1	7	0	431	
% Entrepreneurs Financed by Investors in Same Province, Including Foreign, Excluding Unknown		58.97%	40.00%	NA	0.00%	82.76%	93.24%	0.00%	100.00%	14.29%	NA		82.81%

Table A7. Are Entrepreneurs and Investors Located in the Same Province?

Panel A. All types of entrepreneurs and all types of investors, over all years, 1991 (Quarter 1) - 2003 (Quarter 1), amounts invested < $100,000 (only)

This table presents the number of investments by all types of private equity investors and by entrepreneurs (of all types), for each province, for amounts invested < $100,000 (only). The location of the entrepreneur is based on their place of business (or primary place, in a minority of cases where entrepreneurs carried on business in more than 1 province), as recorded by Macdonald and Associates, Ltd. The location of the investor is recorded as follows: if the investor has an office in the same province as the entrepreneur, then only that province is recorded; otherwise, the office in the primary other province of residence is recorded in this table. 13729 observations. 1991 Quarter 1 to 2003 Quarter 1.

		Primary Location of Entrepreneurial Firm											% Investors Financing Entrepreneurs in Same Province
		BC	AB	SK	MB	ON	QC	NF	NB	NS	PEI	Total	
Primary Location of Investor	BC	83	1	0	0	2	0	0	0	0	0	86	96.51%
	AB	3	14	0	0	2	0	0	0	0	0	19	73.68%
	SK	0	1	18	0	0	0	0	0	0	0	19	94.74%
	MB	1	0	0	44	0	0	0	1	1	0	47	93.62%
	ON	21	19	4	1	248	25	0	3	5	0	326	76.07%
	QC	5	2	0	0	12	684	0	0	0	0	703	97.30%
	NF	0	0	0	0	0	0	0	0	0	0	0	NA
	NB	0	0	0	0	1	1	0	7	0	0	9	77.78%
	NS	0	0	0	0	3	0	0	1	19	0	23	82.61%
	PEI	0	0	0	0	0	0	0	0	0	2	2	100.00%
	Foreign	17	2	0	1	76	30	0	0	0	0	126	NA
	Unknown	45	16	0	2	92	97	2	2	0	1	257	NA
	Total	175	55	22	48	436	837	2	14	25	3	1617	
% Entrepreneurs Financed by Investors in Same Province, Including Foreign, Excluding Unknown		63.85%	35.90%	81.82%	95.65%	72.09%	92.43%	NA	58.33%	76.00%	100.00%		82.28%

Table A7. Are Entrepreneurs and Investors Located in the Same Province?

Panel B. All types of entrepreneurs and all types of investors, over all years, 1991 (Quarter 1) - 2003 (Quarter 1), $100,000 < amounts invested < $500,000 (only)

This table presents the number of investments by all types of private equity investors and by entrepreneurs (of all types), for each province, for $100,000 < amounts invested < $500,000 (only). The location of the entrepreneur is based on their place of business (or primary place, in a minority of cases where entrepreneurs carried on business in more than 1 province), as recorded by Macdonald and Associates, Ltd. The location of the investor is recorded as follows: if the investor has an office in the same province as the entrepreneur, then only that province is recorded; otherwise, the office in the primary other province of residence is recorded in this table. 13729 observations. 1991 Quarter 1 to 2003 Quarter 1.

		Primary Location of Entrepreneurial Firm											
		BC	AB	SK	MB	ON	QC	NF	NB	NS	PEI	Total	% Investors Financing Entrepreneurs in Same Province
Primary Location of Investor	BC	361	4	0	0	3	1	0	0	0	0	369	97.83%
	AB	8	46	1	2	3	0	0	0	0	0	60	76.67%
	SK	2	4	49	0	1	0	0	0	0	0	56	87.50%
	MB	3	0	1	148	0	0	0	0	0	0	152	97.37%
	ON	69	63	16	11	1050	78	3	12	21	5	1328	79.07%
	QC	10	18	0	3	48	2075	0	0	1	0	2155	96.29%
	NF	0	0	0	0	0	0	0	0	0	0	0	NA
	NB	0	0	0	0	0	0	0	8	0	0	8	100.00%
	NS	2	0	0	0	3	0	7	7	42	0	61	68.85%
	PEI	0	0	0	0	0	0	0	0	0	3	3	100.00%
	Foreign	29	3	0	0	20	4	0	0	0	0	56	NA
	Unknown	82	27	15	7	123	185	9	2	7	2	459	NA
	Total	566	165	82	171	1251	2343	19	29	71	10	4707	
% Entrepreneurs Financed by Investors in Same Province, Including Foreign, Excluding Unknown		74.59%	33.33%	73.13%	90.24%	93.09%	96.15%	0.00%	29.63%	65.63%	37.50%		89.03%

Table A7. Are Entrepreneurs and Investors Located in the Same Province?

Panel C. All types of entrepreneurs and all types of investors, over all years, 1991 (Quarter 1) - 2003 (Quarter 1), $500,000 amounts invested < $1,000,000 (only)

This table presents the number of investments by all types of private equity investors and by entrepreneurs (of all types), for each province, for $500,000 < amounts invested < $1,000,000 (only). The location of the entrepreneur is based on their place of business (or primary place, in a minority of cases where entrepreneurs carried on business in more than 1 province), as recorded by Macdonald and Associates, Ltd. The location of the investor is recorded as follows: if the investor has an office in the same province as the entrepreneur, then only that province is recorded; otherwise, the office in the primary other province of residence is recorded in this table. 13729 observations. 1991 Quarter 1 to 2003 Quarter 1.

		Primary Location of Entrepreneurial Firm											
		BC	AB	SK	MB	ON	QC	NF	NB	NS	PEI	Total	% Investors Financing Entrepreneurs in Same Province
Primary Location of Investor	BC	233	0	0	0	1	1	0	0	0	0	235	99.15%
	AB	5	32	1	1	2	2	0	0	0	0	43	74.42%
	SK	0	1	42	0	1	0	0	0	0	0	44	95.45%
	MB	1	0	0	67	0	0	0	0	0	0	68	98.53%
	ON	34	31	5	10	622	49	8	7	16	1	783	79.44%
	QC	10	8	0	0	43	892	0	4	0	0	957	93.21%
	NF	0	0	0	0	0	0	0	0	0	0	0	NA
	NB	0	0	0	0	0	0	0	3	0	0	3	100.00%
	NS	0	0	0	0	1	0	4	0	25	0	30	83.33%
	PEI	0	0	0	0	0	0	0	0	0	0	0	NA
	Foreign	22	3	0	0	7	5	0	0	0	0	37	NA
	Unknown	47	22	8	5	88	92	1	2	4	0	269	NA
	Total	352	97	56	83	765	1041	13	16	45	1	2469	
% Entrepreneurs Financed by Investors in Same Province, Including Foreign, Excluding Unknown		76.39%	42.67%	87.50%	85.90%	91.88%	93.99%	0.00%	21.43%	60.98%	0.00%		87.09%

Table A7. Are Entrepreneurs and Investors Located in the Same Province?

Panel D. All types of entrepreneurs and all types of investors, over all years, 1991 (Quarter 1) - 2003 (Quarter 1), $1,000,000 < amounts invested < $5,000,000 (only)

This table presents the number of investments by all types of private equity investors and by entrepreneurs (of all types), for each province, for $1,000,000 < amounts invested < $5,000,000 (only). The location of the entrepreneur is based on their place of business (or primary place, in a minority of cases where entrepreneurs carried on business in more than 1 province), as recorded by Macdonald and Associates, Ltd. The location of the investor is recorded as follows: if the investor has an office in the same province as the entrepreneur, then only that province is recorded; otherwise, the office in the primary other province of residence is recorded in this table. 13729 observations. 1991 Quarter 1 to 2003 Quarter 1.

		Primary Location of Entrepreneurial Firm											
		BC	AB	SK	MB	ON	QC	NF	NB	NS	PEI	Total	% Investors Financing Entrepreneurs in Same Province
Primary Location of Investor	BC	304	3	0	0	2	1	0	0	0	0	310	98.06%
	AB	5	58	2	3	4	1	0	0	0	1	74	78.38%
	SK	3	3	34	0	1	0	0	0	0	0	41	82.93%
	MB	5	0	1	54	10	0	0	1	0	0	71	76.06%
	ON	87	76	11	15	1336	106	3	15	11	1	1661	80.43%
	QC	26	13	0	5	98	1147	1	4	0	0	1294	88.64%
	NF	0	0	0	0	0	0	0	0	0	0	0	NA
	NB	0	0	0	0	0	0	0	0	0	0	0	NA
	NS	0	0	0	0	0	0	2	2	15	0	19	78.95%
	PEI	0	0	0	0	0	0	0	0	0	0	0	NA
	Foreign	25	5	0	0	58	15	0	3	1	0	107	NA
	Unknown	83	26	11	10	166	128	0	6	8	1	439	NA
	Total	538	184	59	87	1675	1398	6	31	35	3	4016	
% Entrepreneurs Financed by Investors in Same Province, Including Foreign, Excluding Unknown		66.81%	36.71%	70.83%	70.13%	88.54%	90.31%	0.00%	0.00%	55.56%	0.00%		82.42%

Table A7. Are Entrepreneurs and Investors Located in the Same Province?

Panel E. All types of entrepreneurs and all types of investors, over all years, 1991 (Quarter 1) - 2003 (Quarter 1), amounts invested > $5,000,000 (only)

This table presents the number of investments by all types of private equity investors and by entrepreneurs (of all types), for each province, for amounts invested > $5,000,000 (only). The location of the entrepreneur is based on their place of business (or primary place, in a minority of cases where entrepreneurs carried on business in more than 1 province), as recorded by Macdonald and Associates, Ltd. The location of the investor is recorded as follows: if the investor has an office in the same province as the entrepreneur, then only that province is recorded; otherwise, the office in the primary other province of residence is recorded in this table. 13729 observations. 1991 Quarter 1 to 2003 Quarter 1.

		Primary Location of Entrepreneurial Firm											
		BC	AB	SK	MB	ON	QC	NF	NB	NS	PEI	Total	% Investors Financing Entrepreneurs in Same Province
Primary Location of Investor	BC	18	0	0	2	1	0	0	0	0	0	21	85.71%
	AB	0	6	0	0	5	0	0	0	0	0	11	54.55%
	SK	0	0	3	0	0	0	0	0	0	0	3	100.00%
	MB	1	0	0	2	3	1	0	0	0	0	7	28.57%
	ON	36	11	3	3	274	29	0	5	3	1	365	75.07%
	QC	4	3	0	1	21	164	1	1	1	0	196	83.67%
	NF	0	0	0	0	0	0	0	0	0	0	0	NA
	NB	0	0	0	0	0	0	0	0	0	0	0	NA
	NS	0	1	0	0	0	0	0	0	0	0	1	0.00%
	PEI	0	0	0	0	0	0	0	0	0	0	0	NA
	Foreign	20	6	0	0	98	8	0	0	0	0	132	NA
	Unknown	23	5	1	5	117	32	0	1	0	0	184	NA
	Total	102	32	7	13	519	234	1	7	4	1	920	
% Entrepreneurs Financed by Investors in Same Province, Including Foreign, Excluding Unknown		22.78%	22.22%	50.00%	25.00%	68.16%	81.19%	0.00%	0.00%	0.00%	0.00%		63.45%

Table A8. Are Entrepreneurs and Investors Located in the Same Province?

Panel A. All types of entrepreneurs and all types of investors, over all years, 1991 (Quarter 1) - 2003 (Quarter 1), deal size < $100,000 (only)

This table presents the number of investments by all types of private equity investors and by entrepreneurs (of all types), for each province, for deal size < $100,000 (only). The location of the entrepreneur is based on their place of business (or primary place, in a minority of cases where entrepreneurs carried on business in more than 1 province), as recorded by Macdonald and Associates, Ltd. The location of the investor is recorded as follows: if the investor has an office in the same province as the entrepreneur, then only that province is recorded; otherwise, the office in the primary other province of residence is recorded in this table. 13729 observations. 1991 Quarter 1 to 2003 Quarter 1.

		Primary Location of Entrepreneurial Firm											% Investors Financing Entrepreneurs in Same Province
		BC	AB	SK	MB	ON	QC	NF	NB	NS	PEI	Total	
Primary Location of Investor	BC	26	1	0	0	2	0	0	0	0	0	29	89.66%
	AB	0	6	0	0	1	0	0	0	0	0	7	85.71%
	SK	0	1	11	0	0	0	0	0	0	0	12	91.67%
	MB	0	0	0	25	0	0	0	0	1	0	26	96.15%
	ON	4	8	2	1	82	8	0	0	4	0	109	75.23%
	QC	1	1	0	0	6	436	0	0	0	0	444	98.20%
	NF	0	0	0	0	0	0	0	0	0	0	0	NA
	NB	0	0	0	0	0	1	0	7	0	0	8	87.50%
	NS	0	0	0	0	1	0	0	0	15	0	16	93.75%
	PEI	0	0	0	0	0	0	0	0	0	2	2	100.00%
	Foreign	2	1	0	0	1	1	0	0	0	0	5	NA
	Unknown	5	7	0	1	6	8	1	0	0	0	28	NA
	Total	38	25	13	27	99	454	1	7	20	2	686	
% Entrepreneurs Financed by Investors in Same Province, Including Foreign, Excluding Unknown		78.79%	33.33%	84.62%	96.15%	88.17%	97.76%	NA	100.00%	75.00%	100.00%		92.71%

Table A8. Are Entrepreneurs and Investors Located in the Same Province?

Panel B. All types of entrepreneurs and all types of investors, over all years, 1991 (Quarter 1) - 2003 (Quarter 1), $100,000 < deal size < $500,000 (only)

This table presents the number of investments by all types of private equity investors and by entrepreneurs (of all types), for each province, for $100,000 < deal size < $500,000 (only). The location of the entrepreneur is based on their place of business (or primary place, in a minority of cases where entrepreneurs carried on business in more than 1 province), as recorded by Macdonald and Associates, Ltd. The location of the investor is recorded as follows: if the investor has an office in the same province as the entrepreneur, then only that province is recorded; otherwise, the office in the primary other province of residence is recorded in this table. 13729 observations. 1991 Quarter 1 to 2003 Quarter 1.

		Primary Location of Entrepreneurial Firm											
		BC	AB	SK	MB	ON	QC	NF	NB	NS	PEI	Total	% Investors Financing Entrepreneurs in Same Province
Primary Location of Investor	BC	148	0	0	0	3	0	0	0	0	0	151	98.01%
	AB	3	28	1	1	1	0	0	0	0	0	34	82.35%
	SK	0	4	43	0	1	0	0	0	0	0	48	89.58%
	MB	0	0	0	106	0	0	0	0	0	0	106	100.00%
	ON	28	24	6	5	646	44	1	6	12	4	776	83.25%
	QC	7	5	0	2	26	1479	0	0	0	0	1519	97.37%
	NF	0	0	0	0	0	0	0	0	0	0	0	NA
	NB	0	0	0	0	0	0	0	7	0	0	7	100.00%
	NS	2	0	0	0	3	0	4	2	27	0	38	71.05%
	PEI	0	0	0	0	0	0	0	0	0	2	2	100.00%
	Foreign	13	0	0	0	7	2	0	0	0	0	22	NA
	Unknown	17	15	2	2	44	105	2	3	2	2	194	NA
	Total	218	76	52	116	731	1630	7	18	41	8	2897	
% Entrepreneurs Financed by Investors in Same Province, Including Foreign, Excluding Unknown		73.63%	45.90%	86.00%	92.98%	94.03%	96.98%	0.00%	46.67%	69.23%	33.33%		91.97%

Table A8. Are Entrepreneurs and Investors Located in the Same Province?

Panel C. All types of entrepreneurs and all types of investors, over all years, 1991 (Quarter 1) - 2003 (Quarter 1), $500,000 deal size < $1,000,000 (only)

This table presents the number of investments by all types of private equity investors and by entrepreneurs (of all types), for each province, for $500,000 < deal size < $1,000,000 (only). The location of the entrepreneur is based on their place of business (or primary place, in a minority of cases where entrepreneurs carried on business in more than 1 province), as recorded by Macdonald and Associates, Ltd. The location of the investor is recorded as follows: if the investor has an office in the same province as the entrepreneur, then only that province is recorded; otherwise, the office in the primary other province of residence is recorded in this table. 13729 observations. 1991 Quarter 1 to 2003 Quarter 1.

		Primary Location of Entrepreneurial Firm											
		BC	AB	SK	MB	ON	QC	NF	NB	NS	PEI	Total	% Investors Financing Entrepreneurs in Same Province
Primary Location of Investor	BC	101	2	0	0	0	0	0	0	0	0	103	98.06%
	AB	3	24	0	0	1	0	0	0	0	0	28	85.71%
	SK	0	0	32	0	0	0	0	0	0	0	32	100.00%
	MB	2	0	1	76	0	0	0	0	0	0	79	96.20%
	ON	29	30	6	4	420	28	2	4	13	1	537	78.21%
	QC	8	5	0	1	32	820	0	0	0	0	866	94.69%
	NF	0	0	0	0	0	0	0	0	0	0	0	NA
	NB	0	0	0	0	0	0	0	1	0	0	1	100.00%
	NS	0	0	0	0	1	0	2	1	8	0	12	66.67%
	PEI	0	0	0	0	0	0	0	0	0	1	1	NA
	Foreign	2	2	0	0	2	2	0	0	0	0	8	NA
	Unknown	31	18	5	5	55	83	2	0	4	1	204	NA
	Total	176	81	44	86	511	933	6	6	25	3	1871	
% Entrepreneurs Financed by Investors in Same Province, Including Foreign, Excluding Unknown		69.66%	38.10%	82.05%	93.83%	92.11%	96.47%	0.00%	16.67%	38.10%	50.00%		88.96%

Table A8. Are Entrepreneurs and Investors Located in the Same Province?

Panel D. All types of entrepreneurs and all types of investors, over all years, 1991 (Quarter 1) - 2003 (Quarter 1), $1,000,000 < deal size < $5,000,000 (only)

This table presents the number of investments by all types of private equity investors and by entrepreneurs (of all types), for each province, for $1,000,000 < deal size < $5,000,000 (only). The location of the entrepreneur is based on their place of business (or primary place, in a minority of cases where entrepreneurs carried on business in more than 1 province), as recorded by Macdonald and Associates, Ltd. The location of the investor is recorded as follows: if the investor has an office in the same province as the entrepreneur, then only that province is recorded; otherwise, the office in the primary other province of residence is recorded in this table. 13729 observations. 1991 Quarter 1 to 2003 Quarter 1.

		Primary Location of Entrepreneurial Firm											
		BC	AB	SK	MB	ON	QC	NF	NB	NS	PEI	Total	% Investors Financing Entrepreneurs in Same Province
Primary Location of Investor	BC	430	5	0	0	0	1	0	0	0	0	436	98.62%
	AB	11	82	1	3	3	2	0	0	0	0	102	80.39%
	SK	4	1	45	0	2	0	0	0	0	0	52	86.54%
	MB	5	0	0	97	8	0	0	0	0	0	110	88.18%
	ON	73	100	15	19	1302	112	11	17	20	2	1671	77.92%
	QC	10	15	0	3	72	1617	1	1	1	0	1720	94.01%
	NF	0	0	0	0	0	0	0	0	0	0	0	NA
	NB	0	0	0	0	0	0	0	1	0	0	1	NA
	NS	0	0	0	0	1	0	7	2	45	0	55	81.82%
	PEI	0	0	0	0	0	0	0	0	0	0	0	NA
	Foreign	26	7	0	0	32	9	0	1	1	0	76	NA
	Unknown	123	34	19	13	199	203	7	3	11	1	613	NA
	Total	682	244	80	135	1619	1944	26	25	78	3	4836	
% Entrepreneurs Financed by Investors in Same Province, Including Foreign, Excluding Unknown		76.92%	39.05%	73.77%	79.51%	91.69%	92.88%	0.00%	4.55%	67.16%	0.00%		85.70%

Table A8. Are Entrepreneurs and Investors Located in the Same Province?

Panel E. All types of entrepreneurs and all types of investors, over all years, 1991 (Quarter 1) - 2003 (Quarter 1), deal size > $5,000,000 (only)

This table presents the number of investments by all types of private equity investors and by entrepreneurs (of all types), for each province, for deal size > $5,000,000 (only). The location of the entrepreneur is based on their place of business (or primary place, in a minority of cases where entrepreneurs carried on business in more than 1 province), as recorded by Macdonald and Associates, Ltd. The location of the investor is recorded as follows: if the investor has an office in the same province as the entrepreneur, then only that province is recorded; otherwise, the office in the primary other province of residence is recorded in this table. 13729 observations. 1991 Quarter 1 to 2003 Quarter 1.

		Primary Location of Entrepreneurial Firm											
		BC	AB	SK	MB	ON	QC	NF	NB	NS	PEI	Total	% Investors Financing Entrepreneurs in Same Province
Primary Location of Investor	BC	294	0	0	2	4	2	0	0	0	0	302	97.35%
	AB	4	16	2	2	10	1	0	0	0	1	36	44.44%
	SK	1	3	15	0	0	0	0	0	0	0	19	78.95%
	MB	4	0	1	11	5	1	0	2	0	0	24	45.83%
	ON	113	38	10	11	1080	95	0	15	7	1	1370	78.83%
	QC	29	18	0	3	86	610	1	8	1	0	756	80.69%
	NF	0	0	0	0	0	0	0	0	0	0	0	NA
	NB	0	0	0	0	1	0	0	2	0	0	3	NA
	NS	0	1	0	0	1	0	0	5	6	0	13	46.15%
	PEI	0	0	0	0	0	0	0	0	0	0	0	NA
	Foreign	70	9	0	1	217	48	0	2	0	0	347	NA
	Unknown	104	22	9	8	282	135	0	7	2	0	569	NA
	Total	619	107	37	38	1686	892	1	41	16	2	3439	
% Entrepreneurs Financed by Investors in Same Province, Including Foreign, Excluding Unknown		57.09%	18.82%	53.57%	36.67%	76.92%	80.58%	0.00%	5.88%	42.86%	0.00%		70.87%

Table A9. Are Entrepreneurs and Investors Located in the Same Province?

Panel A. All types of entrepreneurs and all types of investors, over all years, 1991 (Quarter 1) - 2003 (Quarter 1), Preferred Equity Securities Only

This table presents the number of investments by all types of private equity investors and by entrepreneurs (of all types), for each province, for preferred equity deals (only). The location of the entrepreneur is based on their place of business (or primary place, in a minority of cases where entrepreneurs carried on business in more than 1 province), as recorded by Macdonald and Associates, Ltd. The location of the investor is recorded as follows: if the investor has an office in the same province as the entrepreneur, then only that province is recorded; otherwise, the office in the primary other province of residence is recorded in this table. 13729 observations. 1991 Quarter 1 to 2003 Quarter 1.

		Primary Location of Entrepreneurial Firm											
		BC	AB	SK	MB	ON	QC	NF	NB	NS	PEI	Total	% Investors Financing Entrepreneurs in Same Province
Primary Location of Investor	BC	136	3	0	0	1	0	0	0	0	0	140	97.14%
	AB	5	19	1	1	2	0	0	0	0	0	28	67.86%
	SK	0	1	6	0	0	0	0	0	0	0	7	85.71%
	MB	0	0	0	16	2	0	0	0	0	0	18	88.89%
	ON	33	17	3	3	365	37	1	2	4	0	465	78.49%
	QC	9	0	0	0	26	329	1	0	0	0	365	90.14%
	NF	0	0	0	0	0	0	0	0	0	0	0	NA
	NB	0	0	0	0	0	0	0	0	0	0	0	NA
	NS	0	0	0	0	1	0	0	1	7	0	9	77.78%
	PEI	0	0	0	0	0	0	0	0	0	0	0	NA
	Foreign	18	5	0	0	37	9	0	0	1	0	70	NA
	Unknown	27	11	0	1	48	39	0	0	1	0	127	NA
	Total	228	56	10	21	482	414	2	3	13	0	1229	
% Entrepreneurs Financed by Investors in Same Province, Including Foreign, Excluding Unknown		67.66%	42.22%	60.00%	80.00%	84.10%	87.73%	NA	0.00%	58.33%	NA		79.67%

Table A9. Are Entrepreneurs and Investors Located in the Same Province?

Panel B. All types of entrepreneurs and all types of investors, over all years, 1991 (Quarter 1) - 2003 (Quarter 1), Common Equity Securities Only

This table presents the number of investments by all types of private equity investors and by entrepreneurs (of all types), for each province, for common equity securities (only). The location of the entrepreneur is based on their place of business (or primary place, in a minority of cases where entrepreneurs carried on business in more than 1 province), as recorded by Macdonald and Associates, Ltd. The location of the investor is recorded as follows: if the investor has an office in the same province as the entrepreneur, then only that province is recorded; otherwise, the office in the primary other province of residence is recorded in this table. 13729 observations. 1991 Quarter 1 to 2003 Quarter 1.

		Primary Location of Entrepreneurial Firm											% Investors Financing Entrepreneurs in Same Province
		BC	AB	SK	MB	ON	QC	NF	NB	NS	PEI	Total	
Primary Location of Investor	BC	277	1	0	0	5	1	0	0	0	0	284	97.54%
	AB	6	52	1	4	4	1	0	0	0	1	69	75.36%
	SK	2	2	46	0	0	0	0	0	0	0	50	92.00%
	MB	4	0	1	100	10	0	0	0	0	0	115	86.96%
	ON	73	70	12	13	1008	89	1	9	9	5	1289	78.20%
	QC	13	24	0	3	62	1708	1	5	0	0	1816	94.05%
	NF	0	0	0	0	0	0	0	0	0	0	0	NA
	NB	0	0	0	0	1	0	0	5	0	0	6	83.33%
	NS	0	0	0	0	2	0	2	4	15	0	23	65.22%
	PEI	0	0	0	0	0	0	0	0	0	1	1	100.00%
	Foreign	24	5	0	1	82	17	0	1	0	0	130	NA
	Unknown	90	21	13	8	155	179	1	5	6	3	481	NA
	Total	489	175	73	129	1329	1995	5	29	30	10	4264	
% Entrepreneurs Financed by Investors in Same Province, Including Foreign, Excluding Unknown		69.42%	33.77%	76.67%	82.64%	85.86%	94.05%	0.00%	20.83%	62.50%	14.29%		84.91%

Table A9. Are Entrepreneurs and Investors Located in the Same Province?

Panel C. All types of entrepreneurs and all types of investors, over all years, 1991 (Quarter 1) - 2003 (Quarter 1), Convertible Preferred Equity Securities Only

This table presents the number of investments by all types of private equity investors and by entrepreneurs (of all types), for each province, for convertible preferred equity securities (only). The location of the entrepreneur is based on their place of business (or primary place, in a minority of cases where entrepreneurs carried on business in more than 1 province), as recorded by Macdonald and Associates, Ltd. The location of the investor is recorded as follows: if the investor has an office in the same province as the entrepreneur, then only that province is recorded; otherwise, the office in the primary other province of residence is recorded in this table. 13729 observations. 1991 Quarter 1 to 2003 Quarter 1.

		Primary Location of Entrepreneurial Firm											
		BC	AB	SK	MB	ON	QC	NF	NB	NS	PEI	Total	% Investors Financing Entrepreneurs in Same Province
Primary Location of Investor	BC	211	1	0	1	1	0	0	0	0	0	214	98.60%
	AB	3	9	0	1	3	2	0	0	0	0	18	50.00%
	SK	1	0	5	0	0	0	0	0	0	0	6	83.33%
	MB	1	0	0	15	0	1	0	0	0	0	17	88.24%
	ON	27	23	2	2	394	25	5	8	9	0	495	79.60%
	QC	11	0	0	0	28	240	0	1	0	0	280	85.71%
	NF	0	0	0	0	0	0	0	0	0	0	0	NA
	NB	0	0	0	0	0	0	0	2	0	0	2	100.00%
	NS	0	1	0	0	1	0	6	3	14	0	25	56.00%
	PEI	0	0	0	0	0	0	0	0	0	3	3	100.00%
	Foreign	20	2	0	0	31	6	0	2	0	0	61	NA
	Unknown	40	8	3	1	68	50	6	4	2	0	182	NA
	Total	314	44	10	20	526	324	17	20	25	3	1303	
% Entrepreneurs Financed by Investors in Same Province, Including Foreign, Excluding Unknown		77.01%	25.00%	71.43%	78.95%	86.03%	87.59%	0.00%	12.50%	60.87%	100.00%		79.66%

Table A9. Are Entrepreneurs and Investors Located in the Same Province?

Panel D. All types of entrepreneurs and all types of investors, over all years, 1991 (Quarter 1) - 2003 (Quarter 1), Debt Securities Only

This table presents the number of investments by all types of private equity investors and by entrepreneurs (of all types), for each province, for debt securities (only). The location of the entrepreneur is based on their place of business (or primary place, in a minority of cases where entrepreneurs carried on business in more than 1 province), as recorded by Macdonald and Associates, Ltd. The location of the investor is recorded as follows: if the investor has an office in the same province as the entrepreneur, then only that province is recorded; otherwise, the office in the primary other province of residence is recorded in this table. 13729 observations. 1991 Quarter 1 to 2003 Quarter 1.

		Primary Location of Entrepreneurial Firm											
		BC	AB	SK	MB	ON	QC	NF	NB	NS	PEI	Total	% Investors Financing Entrepreneurs in Same Province
Primary Location of Investor	BC	71	0	0	0	1	1	0	0	0	0	73	97.26%
	AB	1	22	1	0	0	0	0	0	0	0	24	91.67%
	SK	0	0	47	0	0	0	0	0	0	0	47	100.00%
	MB	2	0	0	79	0	0	0	0	0	0	81	97.53%
	ON	35	30	4	9	421	32	2	7	7	0	547	76.97%
	QC	3	9	0	3	25	980	0	0	0	0	1020	96.08%
	NF	0	0	0	0	0	0	0	0	0	0	0	NA
	NB	0	0	0	0	0	0	0	3	0	0	3	100.00%
	NS	0	0	0	0	0	0	0	0	7	0	7	100.00%
	PEI	0	0	0	0	0	0	0	0	0	0	0	NA
	Foreign	1	0	0	0	6	2	0	0	0	0	9	NA
	Unknown	22	14	6	6	43	64	3	1	1	0	160	NA
	Total	135	75	58	97	496	1079	5	11	15	0	1971	
% Entrepreneurs Financed by Investors in Same Province, Including Foreign, Excluding Unknown		62.83%	36.07%	90.38%	86.81%	92.94%	96.55%	0.00%	30.00%	50.00%	NA		90.01%

Table A9. Are Entrepreneurs and Investors Located in the Same Province?

Panel E. All types of entrepreneurs and all types of investors, over all years, 1991 (Quarter 1) - 2003 (Quarter 1), Convertible Debt Securities Only

This table presents the number of investments by all types of private equity investors and by entrepreneurs (of all types), for each province, for convertible debt securities (only). The location of the entrepreneur is based on their place of business (or primary place, in a minority of cases where entrepreneurs carried on business in more than 1 province), as recorded by Macdonald and Associates, Ltd. The location of the investor is recorded as follows: if the investor has an office in the same province as the entrepreneur, then only that province is recorded; otherwise, the office in the primary other province of residence is recorded in this table. 13729 observations. 1991 Quarter 1 to 2003 Quarter 1.

		Primary Location of Entrepreneurial Firm											
		BC	AB	SK	MB	ON	QC	NF	NB	NS	PEI	Total	% Investors Financing Entrepreneurs in Same Province
Primary Location of Investor	BC	117	0	0	0	0	0	0	0	0	0	117	100.00%
	AB	2	20	1	0	2	0	0	0	0	0	25	80.00%
	SK	1	1	9	0	1	0	0	0	0	0	12	75.00%
	MB	2	0	0	41	0	0	0	1	0	0	44	93.18%
	ON	27	19	4	3	479	42	3	11	18	1	607	78.91%
	QC	5	6	0	1	36	516	0	1	1	0	566	91.17%
	NF	0	0	0	0	0	0	0	0	0	0	0	NA
	NB	0	0	0	0	0	0	0	5	0	0	5	100.00%
	NS	0	0	0	0	2	0	4	2	22	0	30	73.33%
	PEI	0	0	0	0	0	0	0	0	0	0	0	NA
	Foreign	9	1	0	0	13	3	0	0	0	0	26	NA
	Unknown	29	10	2	4	59	66	2	1	3	1	177	NA
	Total	192	57	16	49	592	627	9	21	44	2	1609	
% Entrepreneurs Financed by Investors in Same Province, Including Foreign, Excluding Unknown		71.78%	42.55%	64.29%	91.11%	89.87%	91.98%	0.00%	25.00%	53.66%	0.00%		84.43%

Table A9. Are Entrepreneurs and Investors Located in the Same Province?

Panel F. All types of entrepreneurs and all types of investors, over all years, 1991 (Quarter 1) - 2003 (Quarter 1), Warrants Only

This table presents the number of investments by all types of private equity investors and by entrepreneurs (of all types), for each province, for deals involving warrants (only). The location of the entrepreneur is based on their place of business (or primary place, in a minority of cases where entrepreneurs carried on business in more than 1 province), as recorded by Macdonald and Associates, Ltd. The location of the investor is recorded as follows: if the investor has an office in the same province as the entrepreneur, then only that province is recorded; otherwise, the office in the primary other province of residence is recorded in this table. 13729 observations. 1991 Quarter 1 to 2003 Quarter 1.

		Primary Location of Entrepreneurial Firm											
		BC	AB	SK	MB	ON	QC	NF	NB	NS	PEI	Total	% Investors Financing Entrepreneurs in Same Province
Primary Location of Investor	BC	1	0	0	0	0	0	0	0	0	0	1	100.00%
	AB	0	1	0	0	2	0	0	0	0	0	3	33.33%
	SK	0	0	0	0	1	0	0	0	0	0	1	0.00%
	MB	0	0	0	1	0	0	0	0	0	0	1	100.00%
	ON	2	2	0	0	37	0	0	0	0	0	41	90.24%
	QC	0	0	0	0	2	12	0	0	0	0	14	85.71%
	NF	0	0	0	0	0	0	0	0	0	0	0	NA
	NB	0	0	0	0	0	0	0	0	0	0	0	NA
	NS	0	0	0	0	0	0	0	0	1	0	1	100.00%
	PEI	0	0	0	0	0	0	0	0	0	0	0	NA
	Foreign	0	0	0	0	2	0	0	0	0	0	2	NA
	Unknown	0	2	0	0	12	1	0	0	0	0	15	NA
	Total	3	5	0	1	56	13	0	0	1	0	79	
% Entrepreneurs Financed by Investors in Same Province, Including Foreign, Excluding Unknown		33.33%	33.33%	NA	100.00%	84.09%	100.00%	NA	NA	100.00%	NA		82.81%

Table A9. Are Entrepreneurs and Investors Located in the Same Province?

Panel G. All types of entrepreneurs and all types of investors, over all years, 1991 (Quarter 1) - 2003 (Quarter 1), Debt and Common Equity Securities Only

This table presents the number of investments by all types of private equity investors and by entrepreneurs (of all types), for each province, for debt and common equity securities (only). The location of the entrepreneur is based on their place of business (or primary place, in a minority of cases where entrepreneurs carried on business in more than 1 province), as recorded by Macdonald and Associates, Ltd. The location of the investor is recorded as follows: if the investor has an office in the same province as the entrepreneur, then only that province is recorded; otherwise, the office in the primary other province of residence is recorded in this table. 13729 observations. 1991 Quarter 1 to 2003 Quarter 1.

		Primary Location of Entrepreneurial Firm											
		BC	AB	SK	MB	ON	QC	NF	NB	NS	PEI	Total	% Investors Financing Entrepreneurs in Same Province
Primary Location of Investor	BC	7	0	0	0	0	0	0	0	0	0	7	100.00%
	AB	0	6	0	0	0	0	0	0	0	0	6	100.00%
	SK	0	1	4	0	0	0	0	0	0	0	5	80.00%
	MB	0	0	0	9	0	0	0	0	0	0	9	100.00%
	ON	5	6	3	2	125	4	0	1	0	0	146	85.62%
	QC	2	3	0	1	7	372	0	0	0	0	385	96.62%
	NF	0	0	0	0	0	0	0	0	0	0	0	NA
	NB	0	0	0	0	0	0	0	2	0	0	2	100.00%
	NS	0	0	0	0	0	0	0	0	4	0	4	100.00%
	PEI	0	0	0	0	0	0	0	0	0	0	0	NA
	Foreign	1	0	0	0	0	2	0	0	0	0	3	NA
	Unknown	7	4	5	2	9	23	0	0	0	0	50	NA
	Total	22	20	12	14	141	401	0	3	4	0	617	
% Entrepreneurs Financed by Investors in Same Province, Including Foreign, Excluding Unknown		46.67%	37.50%	57.14%	75.00%	94.70%	98.41%	NA	66.67%	100.00%	NA		93.30%

Table A9. Are Entrepreneurs and Investors Located in the Same Province?

Panel I. All types of entrepreneurs and all types of investors, over all years, 1991 (Quarter 1) - 2003 (Quarter 1), Common and Preferred Equity Securities Only

This table presents the number of investments by all types of private equity investors and by entrepreneurs (of all types), for each province, for common and preferred equity securities (only). The location of the entrepreneur is based on their place of business (or primary place, in a minority of cases where entrepreneurs carried on business in more than 1 province), as recorded by Macdonald and Associates, Ltd. The location of the investor is recorded as follows: if the investor has an office in the same province as the entrepreneur, then only that province is recorded; otherwise, the office in the primary other province of residence is recorded in this table. 13729 observations. 1991 Quarter 1 to 2003 Quarter 1.

		Primary Location of Entrepreneurial Firm											
		BC	AB	SK	MB	ON	QC	NF	NB	NS	PEI	Total	% Investors Financing Entrepreneurs in Same Province
Primary Location of Investor	BC	9	0	0	0	0	0	0	0	0	0	9	100.00%
	AB	1	5	0	0	0	0	0	0	0	0	6	83.33%
	SK	0	1	0	0	0	0	0	0	0	0	1	0.00%
	MB	0	0	0	9	0	0	0	0	0	0	9	100.00%
	ON	3	6	2	1	27	2	1	0	0	0	42	64.29%
	QC	1	1	0	0	4	136	0	0	0	0	142	95.77%
	NF	0	0	0	0	0	0	0	0	0	0	0	NA
	NB	0	0	0	0	0	0	0	0	0	0	0	NA
	NS	0	0	0	0	0	0	0	0	1	0	1	100.00%
	PEI	0	0	0	0	0	0	0	0	0	0	0	NA
	Foreign	0	0	0	0	2	0	0	0	0	0	2	NA
	Unknown	5	3	0	0	14	8	0	0	1	0	31	NA
	Total	19	16	2	10	47	146	1	0	2	0	243	
% Entrepreneurs Financed by Investors in Same Province, Including Foreign, Excluding Unknown		64.29%	38.46%	0.00%	90.00%	81.82%	98.55%	0.00%	NA	100.00%	NA		88.21%

Table A9. Are Entrepreneurs and Investors Located in the Same Province?

Panel J. All types of entrepreneurs and all types of investors, over all years, 1991 (Quarter 1) - 2003 (Quarter 1), Other Combinations of Securities Not in Panels A - I Only

This table presents the number of investments by all types of private equity investors and by entrepreneurs (of all types), for each province, for other combinations of securities not in Panels A - I (only). The location of the entrepreneur is based on their place of business (or primary place, in a minority of cases where entrepreneurs carried on business in more than 1 province), as recorded by Macdonald and Associates, Ltd. The location of the investor is recorded as follows: if the investor has an office in the same province as the entrepreneur, then only that province is recorded; otherwise, the office in the primary other province of residence is recorded in this table. 13729 observations. 1991 Quarter 1 to 2003 Quarter 1.

		Primary Location of Entrepreneurial Firm											% Investors Financing Entrepreneurs in Same Province
		BC	AB	SK	MB	ON	QC	NF	NB	NS	PEI	Total	
Primary Location of Investor	BC	170	3	0	1	1	1	0	0	0	0	176	96.59%
	AB	3	22	0	0	3	0	0	0	0	0	28	78.57%
	SK	1	3	29	0	1	0	0	0	0	0	34	85.29%
	MB	2	0	1	45	1	0	0	1	1	0	51	88.24%
	ON	42	27	9	7	674	56	1	4	9	2	831	81.11%
	QC	11	1	0	1	32	669	0	2	1	0	717	93.31%
	NF	0	0	0	0	0	0	0	0	0	0	0	NA
	NB	0	0	0	0	0	1	0	1	0	0	2	50.00%
	NS	2	0	0	0	1	0	1	0	30	0	34	88.24%
	PEI	0	0	0	0	0	0	0	0	0	1	1	NA
	Foreign	40	6	0	0	86	23	0	0	0	0	155	NA
	Unknown	60	23	6	7	178	104	0	2	5	0	385	NA
	Total	331	85	45	61	977	854	2	10	46	3	2414	
% Entrepreneurs Financed by Investors in Same Province, Including Foreign, Excluding Unknown		62.73%	35.48%	74.36%	83.33%	84.36%	89.20%	0.00%	12.50%	73.17%	33.33%		80.88%

Table A10. Are Entrepreneurs and Investors Located in the Same Province?

Panel A. All types of entrepreneurs and all types of investors, over all years, 1991 (Quarter 1) - 2003 (Quarter 1), Non-Syndicated Investments Only

This table presents the number of investments by all types of private equity investors and by entrepreneurs (of all types), for each province, for non-syndicated investments (only). The location of the entrepreneur is based on their place of business (or primary place, in a minority of cases where entrepreneurs carried on business in more than 1 province), as recorded by Macdonald and Associates, Ltd. The location of the investor is recorded as follows: if the investor has an office in the same province as the entrepreneur, then only that province is recorded; otherwise, the office in the primary other province of residence is recorded in this table. 13729 observations. 1991 Quarter 1 to 2003 Quarter 1.

		Primary Location of Entrepreneurial Firm											
		BC	AB	SK	MB	ON	QC	NF	NB	NS	PEI	Total	% Investors Financing Entrepreneurs in Same Province
Primary Location of Investor	BC	246	1	0	0	5	1	0	0	0	0	253	97.23%
	AB	8	94	1	2	4	0	0	0	0	0	109	86.24%
	SK	1	6	94	0	2	0	0	0	0	0	103	91.26%
	MB	7	0	1	226	6	1	0	0	1	0	242	93.39%
	ON	66	82	10	18	1442	87	3	14	31	6	1759	81.98%
	QC	18	19	0	1	83	2597	2	2	1	0	2723	95.37%
	NF	0	0	0	0	0	0	0	0	0	0	0	NA
	NB	0	0	0	0	0	1	0	15	0	0	16	93.75%
	NS	2	1	0	0	4	0	4	0	38	0	49	77.55%
	PEI	0	0	0	0	0	0	0	0	0	3	3	100.00%
	Foreign	15	7	0	0	17	5	0	0	0	0	44	NA
	Unknown	15	23	0	1	52	12	1	2	0	1	107	NA
	Total	378	233	106	248	1615	2704	10	33	71	10	5408	
% Entrepreneurs Financed by Investors in Same Province, Including Foreign, Excluding Unknown		67.77%	44.76%	88.68%	91.50%	92.26%	96.47%	0.00%	48.39%	53.52%	33.33%		89.70%

Table A10. Are Entrepreneurs and Investors Located in the Same Province?

Panel B. All types of entrepreneurs and all types of investors, over all years, 1991 (Quarter 1) - 2003 (Quarter 1), Syndicated Investments Only

This table presents the number of investments by all types of private equity investors and by entrepreneurs (of all types), for each province, for syndicated investments (only). The location of the entrepreneur is based on their place of business (or primary place, in a minority of cases where entrepreneurs carried on business in more than 1 province), as recorded by Macdonald and Associates, Ltd. The location of the investor is recorded as follows: if the investor has an office in the same province as the entrepreneur, then only that province is recorded; otherwise, the office in the primary other province of residence is recorded in this table. 13729 observations. 1991 Quarter 1 to 2003 Quarter 1.

		Primary Location of Entrepreneurial Firm											
		BC	AB	SK	MB	ON	QC	NF	NB	NS	PEI	Total	% Investors Financing Entrepreneurs in Same Province
Primary Location of Investor	BC	753	7	0	2	4	2	0	0	0	0	768	98.05%
	AB	13	62	3	4	12	3	0	0	0	1	98	63.27%
	SK	4	3	52	0	1	0	0	0	0	0	60	86.67%
	MB	4	0	1	89	7	0	0	2	0	0	103	86.41%
	ON	181	118	29	22	2088	200	11	28	25	2	2704	77.22%
	QC	37	25	0	8	139	2365	0	7	1	0	2582	91.60%
	NF	0	0	0	0	0	0	0	0	0	0	0	NA
	NB	0	0	0	0	1	0	0	3	0	0	4	75.00%
	NS	0	0	0	0	3	0	9	10	63	0	85	74.12%
	PEI	0	0	0	0	0	0	0	0	0	2	2	100.00%
	Foreign	98	12	0	1	242	57	0	3	1	0	414	NA
	Unknown	265	73	35	28	534	522	11	11	19	3	1501	NA
	Total	1355	300	120	154	3031	3149	31	64	109	8	8321	
% Entrepreneurs Financed by Investors in Same Province, Including Foreign, Excluding Unknown		69.08%	27.31%	61.18%	70.63%	83.62%	90.03%	0.00%	5.66%	70.00%	40.00%		80.31%

Table A10. Are Entrepreneurs and Investors Located in the Same Province?

Panel C. All types of entrepreneurs and all types of investors, over all years, 1991 (Quarter 1) - 2003 (Quarter 1), Initial (First Round) Investments Only

This table presents the number of investments by all types of private equity investors and by entrepreneurs (of all types), for each province, for initial (first round) investments (only). The location of the entrepreneur is based on their place of business (or primary place, in a minority of cases where entrepreneurs carried on business in more than 1 province), as recorded by Macdonald and Associates, Ltd. The location of the investor is recorded as follows: if the investor has an office in the same province as the entrepreneur, then only that province is recorded; otherwise, the office in the primary other province of residence is recorded in this table. 13729 observations. 1991 Quarter 1 to 2003 Quarter 1.

		Primary Location of Entrepreneurial Firm											% Investors Financing Entrepreneurs in Same Province
		BC	AB	SK	MB	ON	QC	NF	NB	NS	PEI	Total	
Primary Location of Investor	BC	251	3	0	2	5	0	0	0	0	0	261	96.17%
	AB	10	77	2	3	5	0	0	0	0	1	98	78.57%
	SK	2	7	74	0	2	0	0	0	0	0	85	87.06%
	MB	3	0	1	106	6	0	0	1	1	0	118	89.83%
	ON	65	73	12	15	1349	81	3	19	12	7	1636	82.46%
	QC	10	8	0	2	64	1915	1	2	1	0	2003	95.61%
	NF	0	0	0	0	0	0	0	0	0	0	0	NA
	NB	0	0	0	0	1	0	0	10	0	0	11	90.91%
	NS	2	0	0	0	3	0	4	3	43	0	55	78.18%
	PEI	0	0	0	0	0	0	0	0	0	4	4	100.00%
	Foreign	28	3	0	0	60	14	0	1	0	0	106	NA
	Unknown	87	37	28	13	246	232	3	7	4	3	660	NA
	Total	458	208	117	141	1741	2242	11	43	61	15	5037	
% Entrepreneurs Financed by Investors in Same Province, Including Foreign, Excluding Unknown		67.65%	45.03%	83.15%	82.81%	90.23%	95.27%	0.00%	27.78%	75.44%	33.33%		87.48%

Table A10. Are Entrepreneurs and Investors Located in the Same Province?

Panel D. All types of entrepreneurs and all types of investors, over all years, 1991 (Quarter 1) - 2003 (Quarter 1), Staged Financing Rounds 2 - 5 Only

This table presents the number of investments by all types of private equity investors and by entrepreneurs (of all types), for each province, for staged financing rounds 2 - 5 (only). The location of the entrepreneur is based on their place of business (or primary place, in a minority of cases where entrepreneurs carried on business in more than 1 province), as recorded by Macdonald and Associates, Ltd. The location of the investor is recorded as follows: if the investor has an office in the same province as the entrepreneur, then only that province is recorded; otherwise, the office in the primary other province of residence is recorded in this table. 13729 observations. 1991 Quarter 1 to 2003 Quarter 1.

		Primary Location of Entrepreneurial Firm											
		BC	AB	SK	MB	ON	QC	NF	NB	NS	PEI	Total	% Investors Financing Entrepreneurs in Same Province
Primary Location of Investor	BC	600	5	0	0	2	3	0	0	0	0	610	98.36%
	AB	11	75	2	3	11	2	0	0	0	0	104	72.12%
	SK	1	2	55	0	1	0	0	0	0	0	59	93.22%
	MB	8	0	1	158	7	1	0	1	0	0	176	89.77%
	ON	146	113	11	20	1840	152	8	23	32	1	2346	78.43%
	QC	44	30	0	5	126	2474	1	7	1	0	2688	92.04%
	NF	0	0	0	0	0	0	0	0	0	0	0	NA
	NB	0	0	0	0	0	1	0	8	0	0	9	88.89%
	NS	0	1	0	0	3	0	8	7	53	0	72	73.61%
	PEI	0	0	0	0	0	0	0	0	0	1	1	100.00%
	Foreign	64	10	0	1	189	31	0	2	1	0	298	NA
	Unknown	171	53	4	11	290	237	8	6	13	1	794	NA
	Total	1045	289	73	198	2469	2901	25	54	100	3	7157	
% Entrepreneurs Financed by Investors in Same Province, Including Foreign, Excluding Unknown		68.65%	31.78%	79.71%.	84.49%	84.44%	92.87%	0.00%	16.67%	60.92%	50.00%		82.73%

Table A10. Are Entrepreneurs and Investors Located in the Same Province?

Panel E. All types of entrepreneurs and all types of investors, over all years, 1991 (Quarter 1) - 2003 (Quarter 1), Staged Financing Rounds 6 - 10 Only

This table presents the number of investments by all types of private equity investors and by entrepreneurs (of all types), for each province, for staged financing rounds 6 - 10 (only). The location of the entrepreneur is based on their place of business (or primary place, in a minority of cases where entrepreneurs carried on business in more than 1 province), as recorded by Macdonald and Associates, Ltd. The location of the investor is recorded as follows: if the investor has an office in the same province as the entrepreneur, then only that province is recorded; otherwise, the office in the primary other province of residence is recorded in this table. 13729 observations. 1991 Quarter 1 to 2003 Quarter 1.

		Primary Location of Entrepreneurial Firm											
		BC	AB	SK	MB	ON	QC	NF	NB	NS	PEI	Total	% Investors Financing Entrepreneurs in Same Province
Primary Location of Investor	BC	138	0	0	0	2	0	0	0	0	0	140	98.57%
	AB	0	4	0	0	0	1	0	0	0	0	5	80.00%
	SK	2	0	14	0	0	0	0	0	0	0	16	87.50%
	MB	0	0	0	43	0	0	0	0	0	0	43	100.00%
	ON	35	14	12	5	310	49	3	0	11	0	439	70.62%
	QC	1	6	0	2	30	522	0	0	0	0	561	93.05%
	NF	0	0	0	0	0	0	0	0	0	0	0	NA
	NB	0	0	0	0	0	0	0	0	0	0	0	NA
	NS	0	0	0	0	1	0	1	0	5	0	7	71.43%
	PEI	0	0	0	0	0	0	0	0	0	0	0	NA
	Foreign	21	6	0	0	10	16	0	0	0	0	53	NA
	Unknown	22	6	3	4	45	63	1	0	2	0	146	NA
	Total	219	36	29	54	398	651	5	0	18	0	1410	
% Entrepreneurs Financed by Investors in Same Province, Including Foreign, Excluding Unknown		70.05%	13.33%	53.85%	86.00%	87.82%	88.78%	0.00%	NA	31.25%	NA		81.96%

Table A10. Are Entrepreneurs and Investors Located in the Same Province?

Panel F. All types of entrepreneurs and all types of investors, over all years, 1991 (Quarter 1) - 2003 (Quarter 1), Staged Financing Rounds 11 - 15 Only

This table presents the number of investments by all types of private equity investors and by entrepreneurs (of all types), for each province, for staged financing rounds 11 - 15 (only). The location of the entrepreneur is based on their place of business (or primary place, in a minority of cases where entrepreneurs carried on business in more than 1 province), as recorded by Macdonald and Associates, Ltd. The location of the investor is recorded as follows: if the investor has an office in the same province as the entrepreneur, then only that province is recorded; otherwise, the office in the primary other province of residence is recorded in this table. 13729 observations. 1991 Quarter 1 to 2003 Quarter 1.

		Primary Location of Entrepreneurial Firm											% Investors Financing Entrepreneurs in Same Province
		BC	AB	SK	MB	ON	QC	NF	NB	NS	PEI	Total	
Primary Location of Investor	BC	10	0	0	0	0	0	0	0	0	0	10	100.00%
	AB	0	0	0	0	0	0	0	0	0	0	0	NA
	SK	0	0	3	0	0	0	0	0	0	0	3	100.00%
	MB	0	0	0	8	0	0	0	0	0	0	8	100.00%
	ON	1	0	4	0	31	5	0	0	1	0	42	73.81%
	QC	0	0	0	0	2	51	0	0	0	0	53	96.23%
	NF	0	0	0	0	0	0	0	0	0	0	0	NA
	NB	0	0	0	0	0	0	0	0	0	0	0	NA
	NS	0	0	0	0	0	0	0	0	0	0	0	NA
	PEI	0	0	0	0	0	0	0	0	0	0	0	NA
	Foreign	0	0	0	0	0	1	0	0	0	0	1	NA
	Unknown	0	0	0	1	5	2	0	0	0	0	8	NA
	Total	11	0	7	9	38	59	0	0	1	0	125	
% Entrepreneurs Financed by Investors in Same Province, Including Foreign, Excluding Unknown		90.91%	NA	42.86%	100.00%	93.94%	89.47%	NA	NA	0.00%	NA		88.03%

Fragmentation and the Canadian Stock Markets

Research Study Prepared for the
Wise Persons' Committee

Douglas Cumming
Aditya Kaul
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October 2, 2003

Fragmentation and the Canadian Stock Markets

Biographies

Douglas Cumming

Douglas Cumming, B.Com. (Hons.), M.A., J.D., Ph.D., CFA, is currently an Assistant Professor of Finance, Economics and Law at the University of Alberta School of Business, and has recently accepted the position of Associate Professor of Finance at the University of New South Wales School of Banking and Finance. He has also held / will hold the following visiting professorships: ABN AMRO Bank Visiting Professor of Finance at the University of Amsterdam Graduate School of Business (2002, 2003),Center for Financial Studies, University of Frankfurt Visiting Scholar (2004), and University of Cambridge Judge Institute of Management Visiting Scholar (2004). Dr. Cumming's research is primarily focused on private equity and venture capital, with a focus on international differences in private equity and venture capital markets, including the European, North American and Asia-Pacific private equity and venture capital markets.

Aditya Kaul

Aditya Kaul is currently an Associate Professor of Finance at the University of Alberta. He joined the business faculty in 1996 with a PhD in Finance from the University of Rochester. His research interests are in the areas of market microstructure, international finance and asset pricing. Dr. Kaul's work has been published in the Journal of Finance and the Journal of Financial Economics, and has been presented at major academic conferences in North America. He is the recipient of several research awards including the 1999 Toronto Society of Financial Analysts award for his study on the effects of changes in the definition of the public float on the Toronto Stock Exchange, and a 2000 Q-Group award for his study of common effects in trading activity, prices and trading costs. He has consulted for government organizations and private firms in Canada and the United States and held a visiting position at the University of Oregon in 2000-2001.

Vikas Mehrotra

Dr. Vikas Mehrotra has been a faculty member at the University of Alberta since 1992, after graduating from the University of Oregon with a doctorate in Finance. He currently holds the position of Associate Dean, MBA Programs, as well as the Collins chair in Finance, at the School of Business there. From July-2001 through June-2002, Dr. Mehrotra was a visiting professor of Finance at the prestigious Kenan-Flagler Business School at the University of North Carolina. Dr. Mehrotra's work deals with corporate restructuring, capital structure, and financial markets. His studies have been published in leading finance journals such as the Journal of Finance, the Journal of Financial Economics, and the Review of Financial Studies.

Fragmentation and the Canadian Stock Markets

Executive Summary

The discussion and analysis of regional and sectoral differences in Canadian markets typically focuses on the characteristics of firms in different provinces and/or the different components of general economic activity in different provinces. The likely reason for this focus on firms in different locations is that data on investor location for companies that are publicly traded on Canada's stock exchanges are difficult, if not impossible, to obtain. In our companion paper, we analyze private equity data that match the provinces of location of the investor and investee. Unfortunately, such location data are confined to Canada's private equity markets, so we are unable to use investor location data in this report. As described below, however, we are able to draw inferences regarding regional fragmentation in Canada by carrying out a rigorous quantitative analysis of the degree of fragmentation of Canada's stock exchanges. Our analysis contributes to the core of the debate on securities regulatory reform for publicly traded companies.

Our empirical analysis of market fragmentation is based on an examination of secondary market trading on the Alberta Stock Exchange (ASE), the Vancouver Stock Exchange (VSE), the TSX Venture Exchange and the Toronto Stock Exchange (TSX). We focus our examination on prices and volume, which are the outcomes of all ownership decisions, and therefore provide implied information about relevant firm characteristics. For example, if there are important regional or sectoral differences across firms listed on regional exchanges, these will be manifested in distinct price and volume patterns. By contrast, if ownership and trading are well dispersed, returns and volume will be highly correlated across markets.

We provide an analysis of data comprising several million observations from the ASE, the VSE, the TSX Venture Exchange and the TSX. We document differences across these stock markets in terms of price levels, price volatility, bid-ask spreads, and trading volume. We also study the price and volume co-movement across these markets as a measure of the interconnectedness of the Canadian public equity markets. Finally, we examine the differences in each of these variables (prices, volatility, spreads, volume, and co-movement) in the pre- and post-TSX Venture Exchange formation periods, as well as differences depending on stock prices (e.g. penny stocks versus blue chip stocks) and trading volume.

Our key findings are as follows. First, we document increases in trading volume for VSE-listed stocks (though, surprisingly, not for ASE-listed stocks) after the formation of the TSX Venture Exchange. The formation of the TSX Venture Exchange brought about regulatory changes that lowered the uniqueness of the ASE and VSE and made them part of a national market. While we are puzzled by the ASE results, it is worth noting that the decline in volume for ASE stocks is substantially lower than the increase for VSE stocks. The most plausible explanation for the increased trading volume in VSE-listed stocks is increased interest in, and ownership of, VSE companies by residents in different jurisdictions in Canada in the post-TSX Venture Exchange period. Our correlation figures (discussed below) confirm this interpretation.

Second, comparing the correlations of returns and volume across markets, we show the extent of equity market integration has fluctuated through time, but was at impressive levels as long as five years ago, and remains strong till 2002, the most recent complete year for our data. The strong correlations suggest that the TSX Venture Exchange and the TSX have been relatively well integrated for some time, and that market participants on the TSX and TSX Venture Exchange are not distinct and separate.

Third, our findings speak to an issue that is often overlooked in the analysis of securities regulation in Canada. The issue is the following: do regional differences in economic activity give rise to differences in regulatory structures across provinces, or do differences in regulatory structures give rise to differences in economic activity across provinces? Our analysis compares the correlation in stock returns and volume for the ASE and the VSE both before and after the formation of the TSX Venture Exchange, which was associated with a significant harmonization of regulations and regulators for the exchanges, at least across the provinces of Alberta and British Columbia. The correlation for ASE and VSE returns and volume increased immediately after the formation of the TSX Venture Exchange, suggesting that a unified regulatory structure promotes integration. A longer-term comparison of the correlations suggests that these beneficial effects are most pronounced in the year following the merger, and revert to more modest pre-merger levels by the end of the second year following the event.

Finally, we document differences in average price levels, trading activity and trading costs between the TSX Venture Exchange and the TSX. Somewhat contrary to popular beliefs, we show striking similarities in listing firm characteristics across markets, notably, the large fractions of low priced and thinly traded stocks in both markets. Approximately one in three stocks on the TSX trades at a price of less than one dollar – one normally does not associate “penny stocks” with the TSX, the senior stock market in Canada. Similarly, we find that many stocks, not only on the TSX Venture Exchange, but also on the TSX, are thinly traded. We find that returns and volume co-move strongly for low-priced stocks on the TSX Venture Exchange and the TSX, for high-priced stocks at the two venues, and for actively- and thinly traded stocks. This finding raises questions about the efficacy of regulating local markets from a sectoral or industry perspective alone. Additionally, these results suggest that stocks with similar attributes but traded in different markets might benefit from similar Canada-wide regulations.

Our analysis points to a different set of policy implications than those currently offered. Instead of an array of disparate regulations across the regions, an alternative mechanism for regulating securities markets would involve a *regulatory umbrella* spanning mini-regulatory frameworks based on differences in firm characteristics (such as market capitalization, trading volume, etc). This umbrella approach is somewhat different from the passport approach or the ‘one-size-fits-all’ options currently under consideration.

Fragmentation and the Canadian Stock Markets[1]

1. Introduction

The discussion and analysis of regional and sectoral differences in Canadian markets typically focuses on the characteristics of firms in different provinces and/or the different components of general economic activity in different provinces. A likely reason for this focus on the characteristics of firms in different locations is that investor location data do not exist for publicly traded companies on Canada's stock exchanges. In our companion paper (Cumming, Kaul and Mehrotra, 2003a), we analyze private equity data that match the province of location of the investor and investee. Unfortunately, such location data are confined to Canada's private equity markets. Ownership data for stock markets do not exist, at least not in Canada.[2]

Given the dearth of ownership data for publicly traded companies, there are two possible approaches to study regional and sectoral fragmentation in Canadian stock markets. The first approach involves analysis of firm characteristics and economic differences in different regions. This type of analysis would apply the following reasoning. For example, in the U.S. context, given that computer companies tend to be located in Silicon Valley, oil and gas companies in Texas, biotechnology companies in Massachusetts, and financial service firms in New York, etc., one may reason that different securities laws are appropriate for these different regions or different industries. As discussed in Section 8 of this paper, this type of reasoning says little, if anything, about the degree of market fragmentation beyond describing local concentration of particular industry sectors.

The second approach involves an analysis of trading activity on the different exchanges. Our paper follows this approach. This approach recognizes the fact that capital markets comprise not only firms but also investors. This is an important difference relative to the first approach that focuses only on firms. It seems logical that investors should not be ignored when studying market fragmentation in the context of securities regulation because, among other reasons, securities regulation is designed for the purpose of investor protection.

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1 We are grateful to members of the Alberta Securities Commission, Denise Hendrickson, David Linder, Stephen Murison and Stephen Sibold, and of the British Columbia Securities Commission, Brent Aitken, Louise Gauvin, Doug Hyndman, Wayne Redwick and Christina Wolf, for generously sharing their time and views with us and for helping us to obtain the data used in this analysis, and to Doug Harris for comments that have greatly improved the analysis and exposition.

2 Coval and Moskowitz (2003a, b) have obtained ownership data for a group of U.S. mutual funds. Their data, however, obviously do not completely characterize the U.S. economy. The results are nevertheless interesting as they report a preference for mutual fund investors to invest in publicly traded companies that are geographically proximate (with 100 kilometers) to their investee firms. They also show an informational advantage to being geographically proximate to investees, with average annual returns that are 2.67% higher for mutual funds with a geographically proximate investment strategy. Similar data analysis by Woidtke et al. (2003) also shows the importance of investor identity. Certain datasets (e.g. Thompson Financial Database in the U.S.) contain ownership information for large shareholders (at >10% ownership levels), as trading among owners with a significant stake must be documented. These datasets, too, do not characterize trading activity and ownership for all investors and all stocks. Our interest is in examining integration across a complete set of stocks listed on Canada's stock exchanges.

We believe that the findings in this paper contribute to the core of the debate on integration versus fragmentation in Canada's public equity markets. We hope to shift the debate on the economics of securities regulation away from regional and sectoral analyses of firms, and toward the recognition that integration involves not only firms but also, more importantly, investors and trading outcomes.

Our empirical analysis of market fragmentation is based on an examination of trading activity on the Alberta Stock Exchange (ASE), the Vancouver Stock Exchange (VSE), the TSX Venture Exchange and the TSX. We focus our examination on prices and volume, which are the outcomes of all ownership decisions, and therefore provide implied information about relevant firm characteristics. For example, if there are important regional or sectoral differences across firms listed on regional exchanges, these will be manifested in distinct price and volume patterns. By contrast, if ownership and trading are well dispersed, returns and volume will be highly correlated across markets.

We provide an analysis of data comprising several million observations from the ASE, the VSE, the TSX Venture Exchange and the TSX. We document differences across these stock markets in terms of price levels, price volatility, bid-ask spreads, and trading volume. We also study the price and volume correlations across these markets as a measure of the interconnectedness of Canada's equity markets. Finally, we examine the differences in each of these variables (prices, volatility, spreads, volume, and correlations) in the pre- and post-TSX Venture Exchange formation periods, as well as differences depending on stock prices (e.g. penny stocks versus blue chip stocks) and trading volume.

The data indicate the following key results. First, we document increases in trading volume for VSE-listed stocks (though not the ASE-listed stocks) after the formation of the TSX Venture Exchange. The formation of the TSX Venture Exchange brought about regulatory changes that lowered the uniqueness of the ASE and VSE and made them part of a national market. While we are puzzled by the ASE results, it is worth noting that the decline in volume for ASE stocks is substantially lower than the increase for VSE stocks. The most plausible explanation for the higher trading volume in VSE-listed stocks is increased interest in, and ownership of, VSE companies by residents in different jurisdictions in Canada in the post-TSX Venture Exchange period. Our correlation figures (discussed below) confirm this interpretation.

Second, we compute the correlations between returns and volume for the ASE and the VSE and the TSX, and then for the TSX Venture Exchange and the TSX and find that the correlations and, therefore, the extent of equity market integration have fluctuated through time. However, integration was at impressive levels as long as five years ago. In fact, the return correlations were higher in 1997 than in 2002. The large correlations suggest that the TSX Venture Exchange and the TSX have been relatively well integrated for some time, and that market participants on the TSX and TSX Venture Exchange are homogenous.

Third, our findings speak to an issue that is often overlooked in the analysis of securities regulation in Canada. The issue is the following: do regional differences in economic activity give rise to differences in regulatory structures across provinces, or do differences in regulatory structures give rise to differences in economic activity across provinces? Our analysis compares

the correlation in stock returns for the ASE and the VSE both before and after the formation of the TSX Venture Exchange, which was associated with a significant harmonization of regulations and regulators for the exchanges, at least across the provinces of Alberta and British Columbia. The correlation for ASE and VSE returns and volume increased immediately after the formation of the TSX Venture Exchange, suggesting that a unified regulatory structure might promote integration. However, a longer-term comparison of the correlations suggests that these beneficial effects are most pronounced in the year following the merger, and revert to more modest pre-merger levels by the end of the second year following the event.

Finally, we document differences in average price levels, trading activity and trading costs between the TSX Venture Exchange and the TSX. However, there are also striking similarities across markets, notably, the large fractions of low priced and thinly traded stocks in both markets. Approximately one in three stocks on the TSX trades at a price less than one dollar—one normally does not associate "penny stocks" with the TSX, the senior stock market in Canada. Similarly, we find that many stocks, not only on the TSX Venture Exchange, but also on the TSX, are thinly traded. We find that returns and volume co-move strongly for low-priced stocks on the TSX Venture Exchange and the TSX, for high-priced stocks at the two venues, and for actively- and thinly traded stocks.

Overall, our conclusions are that the regional equity markets in Canada are well integrated along key dimensions; specifically, we note that prices and trading activity in regional markets co-move to a significant degree even after controlling for firm-specific characteristics such as price and volume. These findings call into question sector-specific regulations across the regional markets: after all, when thinly-traded stocks on the TSX Venture Exchange co-move with thinly-traded stocks on the TSX, it is difficult to argue that each market needs idiosyncratic regulation. Instead, we suggest a regulatory model based on trading volume or price levels (or, by extension, market capitalization or firm size) that would remain the same across provincial boundaries.

The rest of this report is organized as follows. Section 2 provides a historical perspective on the stock exchanges in Canada, and the degree to which the merger of the ASE and VSE exchanges gave rise to a (partial) harmonization of regulations on the CDNX (which later became the TSX Venture Exchange). The daily trading data from the ASE, the VSE, the TSX Venture Exchange and the TSX are described in Section 3. Section 4 provides descriptive statistics on price levels, price volatility, bid-ask spreads, and trading volume for the TSX Venture Exchange and the TSX. Section 5 provides an analysis of co-movement, not only for all stocks, but also for different groups of stocks sorted by trading volume or price. Section 6 documents the effects of the formation of the TSX Venture Exchange on market quality. In Section 7, we discuss the implications of the co-movement analysis for the purpose of securities regulatory reform. Section 8 compares the approach taken in this paper to the alternative approach of studying regional or sectoral concentration of firms. Section 9 concludes. Appendix I summarizes our analysis to verify the robustness of our results.

2. Stock Exchanges and Securities Regulation in Canada

Our empirical analysis focuses on trading on the regional stock exchanges in Canada. We also analyse the merger of the Alberta and Vancouver stock exchanges to form the CDNX (later the TSX Venture Exchange), an event that involved a (partial) merging of rules and regulators governing the exchange. This merging of rules allows us to study the effect of a partial harmonization of rules and regulators on trading patterns and outcomes. In this section, we review relevant details of the historical development of Canada's equity markets.

Five stock exchanges existed in Canada prior to November 26, 1999: the Montreal Exchange (ME), the Toronto Stock Exchange (TSE; TSX after April 8, 2002), the Winnipeg Stock Exchange (WSE), the Alberta Stock Exchange (ASE) and the Vancouver Stock Exchange (VSE). On November 26, 1999, the VSE, the ASE, and the Canadian Dealing Network (CDN) arm of the TSE (TSX) merged to form the Canadian Venture Exchange (CDNX). The ME became the exchange for derivatives trading, and its junior securities were transferred to the CDNX, and its senior securities to the TSE (TSX).[3] On November 27, 2000, the WSE merged with the CDNX. On May 30, 2002, the CDNX changed its name to the TSX Venture Exchange, pursuant to the acquisition of the CDNX by the TSX.[4]

The formation of the CDNX out of the ASE, VSE, CDN and ME, and subsequently the WSE, gave rise to a common rulebook for CDNX listed companies. The Alberta Securities Commission (ASC) and British Columbia Securities Commission (BCSC) had joint oversight of the CDNX, ending the Ontario Securities Commission's (OSC) oversight of the CDN, and thereafter the Manitoba Securities Commission's oversight of the WSE. This harmonization was extended to cover the regulations pertaining to the exchanges themselves, but did not pertain to the provincial securities acts, or to the ASC and BCSC.

The ASC and BCSC have both characterized the merged rulebook of the CDNX as a "cherry-picked" combination of, for the most part, the more stringent regulations from both exchanges.[5] But despite the common policy manual for the CDNX, there is anecdotal evidence that the enforcement of the rules was somewhat different in Alberta and British Columbia.[6] For instance, the VSE had been wooing foreign directors for listed companies and foreign investors for years while the ASC preferred to deal with players it knew.

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3 The realignment initially did not cover small companies listed on the ME, and approximately 150 companies not eligible for listing on the TSE continued to be listed on the ME. In September 2001, a large number of these firms transferred from the ME to the CDNX.

4 Sources: www.tsx.com/en/pdf/TSXHistory.pdf; http://canadagazette.gc.ca/partl/2003/20030726/html/regle2-e.html#i2.

5 Source: authors' meetings with the Alberta Securities Commission (ASC) on June 13, 2003, the British Columbia Securities Commission June 16, 2003, and the Investment Dealers Association (IDA) on July 2, 2003, summarized by Cumming, Kaul and Mehrotra (2003b).

6 *Ibid.*

As a second illustration of differences in expertise and philosophy, both the ASC and BCSC expressed the sentiment that the ASC was better at regulating oil and gas companies (that typically have significant operating revenues), whereas the BCSC had superior expertise in the regulation of mining stocks, that typically have few, if any, revenues and for which all expenses (including management fees and office expenses) are paid out of the funds raised on the market.

The Investment Dealers Association of Canada (IDA) has expressed the view that one of the main benefits of the ASE-VSE merger was that it helped to overcome the widely-held view that the VSE was rife with insider trading and market manipulation, an impression left over from the 1980s.[7] Despite a huge cleanup of the VSE in the mid- late 1990s, the VSE bore the stigma of low market quality. The fact that the CDNX was headquartered in Alberta, not Vancouver, was intended to reinforce this perception of improved market integrity. In the IDA's view, tangible benefits associated with the formation of the CDNX included the introduction of a unique trading engine and cost savings. The integration of the CDNX into the TSX Group to form the TSX Venture Exchange has brought a similar benefit in terms of a perceived increase in market quality.[8]

Relatively recent initiatives include a revised mandate for the TSX Venture Exchange (as of August 2003) to shift its image from that of a regional Western Canadian exchange to that of a national junior exchange, and to increase listings from across Canada, particularly Ontario and Quebec. Additionally, the Canadian Securities Administrators (CSA, an umbrella organization representing the 13 securities regulatory authorities across Canada) initiated the Uniform Securities Legislation (USL) project in 2001, expected to be adopted in 2004.

A large part of our empirical analysis focuses on the November 26, 1999 merger of the ASE and VSE and we conclude this section with a few additional comments on the details of this event. This merger of the exchanges involved a harmonization of stock exchange rules (generally, the higher regulatory standard from the former ASE or VSE had to be met). The merger did *not* involve a merger of the securities acts in Alberta and British Columbia, nor of the ASC and BCSC. For this reason, the ASE-VSE merger is not a pure test of the effect of rule harmonization on market fragmentation. It is, however, the closest available thing to a pure harmonization of rules and, therefore, for our purposes, an important informative event in the history of Canada's stock exchanges. Our empirical tests isolate the effects of the harmonization on trading activity and market quality by introducing appropriate controls.

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7 *Ibid.*

8 *Ibid.*

3. Data

We have obtained daily data for stocks listed on the ASE and the VSE from March 1997-November 26, 1999, and on the TSX Venture Exchange from November 29, 1999-June 2003.[9] For the purposes of making comparisons, we have also constructed a stock-level dataset for the TSX for the period March 1997 through December 2002.[10] Each of these datasets contains the closing price, bid and ask quotes, and daily trading volume. We divide the sample data into five 12-month periods and carry out our analysis for these 12-month periods. In constructing these intervals, we exclude the two-month period centred on the formation of the CDNX in November 1999, since this is likely to have been a transitional period. Thus, the five intervals examined are November 1, 1997-October 31, 1998, November 1, 1998-October 31, 1999, and the calendar years (i.e. January-December) 2000, 2001 and 2002.

We make use of data for every available stock in each market, and check the general applicability of our results, so-called robustness tests, by examining subsets of the data. Prior work has shown that stock returns and trading costs are influenced by the levels of trading activity and price (see, e.g., Harris, 2002); therefore, we categorize stocks on the basis of volume and price. Specifically, in each 12-month period, we assign each stock to one of three price categories, $P < 1$, $1 \leq P < 5$ and $P \geq 5$, where P is the median price for that period, and to a trading volume quintile formed on the basis of total trading volume in the 12 months. We then repeat our analysis within the price and volume categories. The price categories also serve as a useful proxy for market capitalization categories.

We summarize information on the number of stocks in Table 1. Note that these numbers include non-voting shares, preferred shares, and tracking stocks. For the TSX Venture Exchange the total number of stocks with data is approximately 2900 in 1997 and 1998. Of these, 1700 firms traded in Vancouver and 1200 in Alberta. The drop in the number of firms between 1998 and 1999 is surprising, though the number of firms in 2000 is more consistent with the pre-1999 figures. In excess of 3000 stocks are listed on the TSX Venture Exchange at the end of 2002. The large number of listings reflects the key role of the TSX Venture Exchange as a venue for smaller firms to obtain access to public equity. A comparison of the second and third columns of the table shows that we lose a little over 10% of the firms owing to invalid (negative or zero) prices on the last trading day of the year (this likely reflects thin trading of these stocks, an issue we will return to in the next section). The next three columns provide a breakdown of the firms in terms of the three price categories, and we see that well over 80% of the TSX Venture stocks can be classified as penny stocks.

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9 While the VSE and CDNX datasets are, to the best of our knowledge, comprehensive, the ASE dataset does not have daily data for approximately 40% of the listed stocks, primarily those that did not trade in a given month and halted, suspended, or unique listings. We are grateful to Rob Aldred at the TSX Venture Exchange for helping us to obtain the ASE data.

10 Beyond this section, for the sake of clarity, we refer to the TSE as the TSX and the CDNX as the TSX Venture Exchange even before the dates that the new names became effective.

Turning to the TSX, the number of firms with data has declined by 10% between 1997 and 2002. The fact that the number of listings on the TSX has declined through time reinforces the importance of the TSX Venture Exchange as a source of capital for unheralded firms. The number of stocks with invalid prices at the end of each year is generally similar to that for the TSX Venture Exchange. Since, until recently, the TSX was likely to have been synonymous with the 300 relatively large stocks that comprised the former TSE 300 index, it is worth pointing out that the number of firms on the TSX is well over 1000 in every year. In other words, many smaller firms trade on the TSX and, as with the firms that trade on the TSX Venture Exchange, are also likely to have low prices and thin trading. Approximately 30% of TSX firms are in the lowest price category (price less than one dollar), compared to 80% of the firms on the TSX Venture Exchange. We return to the issue of differences in prices and trading activity across the exchanges in the next section.

4. Market Quality for the TSX Venture Exchange and the TSX

We start by summarizing trading activity, trading costs and prices for stocks on the TSX Venture Exchange and the TSX. The purpose is to provide preliminary evidence on the extent to which the trading environments in these two markets differ. Table 2 provides the cross-sectional medians of the following variables: closing price, daily return volatility, the relative spread and trading volume. These medians are calculated over two one-year windows, November 1, 1998 to October 31, 1999 and January 1, 2000 to December 31, 2000, for all stocks, as well as for stocks in the three price and five volume groupings. First, the time series mean is calculated for each stock; then, the median is calculated across all stocks in a particular grouping (e.g. price category 2). We focus on these one-year windows because they are centred on the formation of the TSX Venture Exchange and provide preliminary evidence of its effects.

In addition to price, we provide descriptive statistics on variables that shed light on trading activity and market quality. Daily return volatility is calculated as the absolute value of the daily close-close return and is a measure of price variability. The relative spread is defined as the dollar spread (the difference between the ask and bid prices) divided by the average of the bid and ask quotes and is a measure of trading costs. Trading volume (the number of shares traded) is a natural measure of trading activity.

Starting with the TSX Venture Exchange in Table 2 Panel A, the mean price increases between the two years in every grouping except price category 3. Across all stocks, the increase is 30% (from 0.24 to 0.32), with the largest increase occurring for the heaviest volume quintile (approximately 40%). These results should however, be interpreted with caution, since the price levels are low – a large majority of stocks trades at prices below $1. There is a substantial price decline in the highest price category (of approximately 60%), but, as shown in Tables 1 and 2, there are relatively few stocks in this category. Rows 3 and 4 show that volatility declines by approximately 15% for all stocks, though it increases for the higher-priced and more actively traded stocks. While we do not separately report statistics for the ASE and VSE, the decline is driven by ASE stocks, since volatility increases for VSE stocks. Likewise, the relative spread declines by approximately 10% across all stocks and in most categories. Trading volume decreases by 10% for all stocks, though there is a 60% increase for stocks in quintile 5

(volume declines by 70% in volume category 1). As with volatility, volume increases for VSE stocks and declines for ASE stocks. Overall, these statistics show generally favourable trends in prices and trading costs between the two periods, consistent with the view that the creation of the TSX Venture Exchange has had a positive effect on market quality. We examine this issue more rigorously in section 6, where we conduct an event study of the effects of the TSX Venture Exchange formation.

Turning to the TSX (Table 2, Panel B), we see that prices increase by approximately 20% between the first and second sample years. Volatility increases for TSX stocks, by 10%-15% for most groupings. Relative spreads are unchanged for many categories, and decline by 20% in price categories 2 and 3 and volume category 3. Finally, volume increases substantially in each category, particularly for the highest price and lower volume stocks.

While the patterns for the TSX Venture Exchange and the TSX are broadly similar, a comparison of the two panels in Table 2 shows a marked disparity in levels between the two markets. For each period and in every grouping, TSX prices are several times higher than prices on the TSX Venture Exchange. Given their lower prices, it is understandable that TSX Venture Exchange stocks display much higher levels of volatility and relative spreads than do the TSX stocks. Finally trading activity is shallower on the TSX Venture Exchange than on the TSX, in part contributing to the higher volatility and spreads on the former.

We also carry out a variance ratio test of market quality. We construct the variance ratio statistic as the weekly return variance divided by 5 times the daily return variance:

$$VR = \frac{\sigma_w^2}{5\sigma_d^2}$$

where σ_w^2 and σ_d^2 denote the variances of weekly and daily returns. If prices follow a ‘random walk’, i.e. prices do not systematically under- or over-react to news, it can be shown that the value of the variance ratio will be 1.0.[11] If prices over-react, daily price changes will be large (equivalently, σ_d^2 will be high) but weekly variances, which incorporate some of the eventual correction of prices, will be relatively low. Hence, the variance ratio will be below 1.0. Similarly, if prices under-react, the variance ratio will be greater than 1.0 (since daily price changes do not reflect all of the news, longer term price changes will be greater than a cumulation of daily changes). Thus, this test allows us to draw inferences about the extent to which prices are efficient.

Table 2C summarizes the results of this variance ratio test for the year before and the year after the formation of the TSX Venture Exchange. For ease of interpretation, we subtract 1 from the variance ratio calculated for each stock. Thus, a variance ratio of zero is consistent with efficient prices, while a negative (positive) variance ratio suggests that stock prices are characterized by over-reaction (under-reaction). The fact that the overall average variance ratio is negative in both markets shows that TSX and TSX Venture Exchange stocks display

[11] See, for instance, Lo and MacKinlay (1988).

overreaction. For TSX Venture stocks, the overreaction has declined slightly between the two years. By contrast, overreaction has increased for TSX stocks. A possible factor is temporary price pressure (a non-zero price impact of trades that is eventually reversed), which has become more serious through time as the volume of trading has increased. The overall averages conceal different patterns for the two markets, with low volume stocks on the TSX Venture Exchange and high volume stocks on the TSX displaying under-reaction (variance ratios above 1.0). Somewhat surprisingly, excepting the top two TSX volume quintiles, over-reaction is more serious on the TSX than on the TSX Venture Exchange, as seen in the larger negative numbers for the former. On the whole, over-reaction appears to be more of a small stock phenomenon, regardless of trading venue.

The averages presented in Table 2 do not provide a picture of the complete distribution of prices and trading activity, e.g. the percentage of firms in each market with prices below \$1 or daily trading volume of less then 1000 shares. To address this issue, we examine the cross-sectional distribution of prices and volume for the TSX Venture Exchange and the TSX for the first trading day in November in each year, 1997-2002 (the first trading day in November is selected randomly). We separate prices into the three categories defined above, i.e. $P < \$1$, $\$1 \leq P < \$5$, and $P \geq \$5$. We form seven categories for volume on the day in question, $Vol = 0$; $0 \leq Vol < 1{,}000$; $1{,}000 \leq Vol < 10{,}000$; $10{,}000 \leq Vol < 100{,}000$; $100{,}000 \leq Vol < 500{,}000$; $500{,}000 \leq Vol < 1{,}000{,}000$; and $Vol \geq 1{,}000{,}000$. To interpret the volume and price frequencies in terms of the actual number of firms in the relevant price or volume category, the reader should multiply the number of firms (in the last column) by the frequency, e.g. 4 firms (=0.2%*1971) have trading volume above \$1,000,000 shares in November 1997.

The top panel of Table 3 presents the results for the TSX Venture Exchange. An overwhelming fraction of stocks in each year consists of penny stocks (recall that stocks in price category 1 have prices below \$1.00), and the percentage of penny stocks has risen through time, from 78% in 1997 to 95% in 2002. Most of this increase occurs between 1997 and 1998. Accompanying the increase in the fraction of penny stocks is a decline in both the fraction and the number of stocks with prices between \$1 and \$5 and those with prices above \$5. For instance, the number of stocks with prices between \$1 and \$5 has dropped from 345 (=0.20*1724) in 1997 to 94 (=0.046*2060) in 2002. The corresponding numbers for the highest priced stocks (prices above \$5) are 34 in 1997 and 12 in 2002.

Moving on to trading activity, we find that TSX Venture Exchange stocks are very thinly-traded. In recent years, in fact, a majority of stocks does not trade at all (i.e. more than 50% of the TSX Venture Exchange stocks are in volume category 1) and the proportion of firms in category 1 has grown larger through time (i.e. has grown from 41% to 62% over this five-year period). Also illustrative of the low level of trading activity are the facts that (a) between 75% and 80% of the firms have a daily volume of less than 1000 shares, and (b) no more than 5% of the firms have volume exceeding 100,000 shares.

The bottom panel of Table 3 presents matching results for the TSX. It is clear that the frequency of low-priced stocks is appreciably lower for the senior market. A majority of stocks (626 stocks, or 50.5%) has a price in excess of \$5 in 1997. While the proportion and number of

stocks in the highest price category declines through time, it still has the largest representation (503 stocks, or in excess of 40%) in 2002. Over this five-year period, the percentage of the lowest priced stocks (prices below $1) increases from just under 20% to just under 30% (their number increases from 241 to 337), and that of the mid-priced stocks declines from 30% to 26% (their number declines from 373 to 290). Thus, even though the price levels of low-priced stocks on the two exchanges are different, there appears to be a trend towards the increasing presence of low-priced stocks in both markets.

As expected, the non-trading frequencies are appreciably lower on the TSX, although a surprisingly significant fraction (as many as 20%) of all TSX listings does not record any trading activity in each year. Fifty percent of TSX stocks have a daily volume of 10,000 shares or more, and 15% of the firms have traded more than 100,000 shares a day in recent years. Thus, on average, TSX stocks are much more actively traded than are TSX Venture Exchange stocks.

The results in Tables 2 and 3 show similarities and differences between the TSX and the TSX Venture Exchange. On the one hand, unsurprisingly, there is a marked difference in the broad levels of prices and trading activity in the two markets. This lends credence to the popular view that the two markets have distinct trading environments. On the other hand, simultaneously, many TSX and TSX Venture Exchange stocks share similar price and trading attributes. That is, the number of low priced and thinly-traded stocks in both markets is substantial. In the next section, we examine the extent to which these two markets are fragmented in terms of co-movement of prices and trading volume.

5. Analysis of Co-movement Across Markets

In this section, we carry out tests of co-movement between the TSX Venture Exchange and TSX, as a direct measure of the interconnectedness of the Canadian public equity markets.[12] As we stated in the introduction, a test of integration must ultimately focus on investors spread across the several geographically distinct markets. If investor sentiment and valuations (translating into trading activity and returns) are seen to be decoupled from each other, we have a strong case for the existence of segmented regional markets. On the other hand, if we find that trading activity and returns are positively correlated across the regional markets, this would favour integrated markets.

The strength of co-movement and changes in the degree of co-movement provide us with additional clues in assessing the degree and direction of market integration in Canada. As we discuss in Section 8, we favour this quantitative approach to assessing market integration as opposed to a more descriptive approach involving cataloguing sectoral and industry differences in listings. While the latter approach tells us something about where oil and gas

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[12] Comovement has been studied by several recent papers, e.g. Lo and Wang (2000), Hasbrouck and Seppi (2001) and Harford and Kaul (2003).

stocks are listed as vis-à-vis bio-tech listings (for instance), it is of limited use in assessing how integrated these separate markets are in terms of trading and price changes from an investor's point of view.[13]

We provide cross-market correlations in returns (i.e. percentage price changes), and show differences in these correlations in the pre- and post-TSX Venture Exchange formation periods, as well as differences depending on volume and stock prices (e.g. penny stocks versus blue chip stocks). We also conduct parallel examinations of the correlations in trading volume on the TSX and the TSX Venture Exchange.

This section is organized as follows. We first examine TSX and TSX Venture Exchange return co-movement in section 5(a), and then follow it with an examination of volume co-movement in section 5(b). In each section, we consider co-movement across all stocks first, and then consider co-movement across trading volume and price portfolios in subsections.

(a) *Co-movement of Daily Stock Returns*

Stock prices are affected both by idiosyncratic and market-wide news. If two markets are completely segmented, common factors do not affect prices in both markets, and the correlation in the returns for the two markets will be low. On the other hand, if the markets are well-integrated, common news should be reflected in prices in both markets, and their returns (price changes) should exhibit a high degree of return correlation. Thus, our first test of integration relies on measuring the correlation between stock returns on the TSX and the TSX Venture Exchange. These results are described in the next three sub-sections.

(i) Return Co-movement Using all Stocks

We study the correlation in daily returns for stocks listed on the TSX Venture Exchange and the TSX Index. If the regional markets and the TSX are well integrated, the correlation in daily returns for stocks on the TSX Venture Exchange and stocks on the TSX should be large and growing through time. Furthermore, if the formation of the TSX Venture Exchange has promoted integration, the return correlations should increase noticeably after this event.[14]

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13 It is clear that the sectoral composition of the two markets will influence the correlations. However, to the extent that the sectoral composition of each market has not changed radically between years, the *trends* in the correlations should still be informative of *changes* in the degree of integration. This is our focus. As an aside, note that the differing composition is likely to drive the correlations towards zero. By contrast, we find respectable correlations, in the region of 40% and as high as 80%. Were we to examine the correlations by sector (a task made impossible by the lack of industry affiliation data), we are confident that these would be even higher.

14 The correlation coefficient lies between +1.0 and –1.0. The sign indicates the direction of association, i.e. whether the variables are directly or inversely related. The size of the coefficient indicates the strength of the association, with closeness to plus or minus 1.0 indicative of a stronger positive or negative association, and zero indicating no association.

In Figure 1, we plot the cumulative returns (which equal long-horizon price changes) for the regional market and the TSX. These plots allow us to see how the two market indexes have evolved from two years prior to the TSX Venture Exchange creation to two years afterwards. (We tabulate and discuss correlations from two years before the formation of the TSX Venture Exchange to three years afterwards, but do not wish to 'overcrowd' the figures.)

Figure 1A displays the cumulative daily returns for the TSE 300 Index and the cumulative equally-weighted returns for the TSX Venture Exchange ("equally-weighted" means that we have taken a simple average of the returns for all stocks in the market on each date). The plot covers the period November 1, 1997 through December 31, 2001, roughly spanning the four years centered on the merger of the ASE and the VSE, while excluding the month on either side of the merger. The period of the merger (November 1, 1999 through December 31, 1999) is anchored as date 0, with the preceding period using data from the ASE and VSE, and the period after this date using data from the TSX Venture Exchange.

Figure 1A shows that the two series generally move together, although far from perfectly. The correlation between these two series is 0.30 in the year before the TSX Venture Exchange formation, and it increases to 0.46 in the year after this event. While the increase in the correlation indicates greater integration following the merger, the level of the correlations is moderate. A possible factor is the differing composition of the two indexes. In particular, the TSE 300 index is a value-weighted index that is dominated by large cap stocks, while the TSX Venture Exchange equally-weighted index assigns a relatively larger weight to small cap stocks.

To address this possibility, we repeat the plot and correlation analysis using an equally-weighted TSX index (which assigns a greater weight to smaller stocks, including a non-zero weight to stocks outside the TSE 300) and the same TSX Venture Exchange equally-weighted index. In Figure 1B, we see that the two series appear to move together closely, although the TSX Venture Exchange cumulative returns are lower than the TSX equally-weighted returns. The correlation between the equally-weighted indexes from the two markets is appreciably higher, both prior to the merger (0.66), and one year after the merger (0.85), although the correlation two years after the merger drops to 0.66. We note two things from these results. First, the return correlation of TSX Venture Exchange stocks is greater with the equally-weighted TSX index (which assigns a greater weight to small stocks) than with the TSE 300 Index. Second, in the immediate aftermath of its creation, the TSX Venture Exchange appears to be more closely integrated with the TSX than the former ASE and VSE were.

To the extent that stocks with higher prices and greater trading volume dominate the TSX (and not the TSX Venture Exchange), these results suggest caution in drawing inferences regarding integration in the case of stocks with fundamentally different characteristics. For example, a concern is that thinly traded stocks may not display a high degree of co-movement simply because of insufficient trades, creating a spurious impression of segmentation. Similarly, stocks with very low prices, so-called penny stocks, might display a low degree of co-movement because of price staleness, or transactions costs, both of which affect penny stocks to a greater

extent vis-à-vis higher-priced stocks.[15] We address this issue by analyzing return co-movement for price and volume sub-groups in the following sections.

(ii) Return Co-movement for Volume Portfolios

In Table 4 we provide the correlations between returns to five portfolios constructed from TSX and TSX Venture Exchange stocks by separating stocks on the basis of volume (we will also refer to these groupings as *volume quintiles*). We focus on the two years immediately surrounding the formation of the TSX Venture Exchange, panels B and C. The columns represent TSX volume quintiles, with quintile 1 consisting of the lowest volume stocks, and the rows denote volume quintiles from the TSX Venture Exchange. The diagonal elements of this matrix are of special interest to us since these denote the return correlations for similar quintiles on the two exchanges.

Over the period November 1, 1998 though October 31, 1999, for example, the return correlation for quintile 1 stocks (the lowest volume category) in the two markets is 0.011, indicating that for thinly traded stocks the two markets were not integrated immediately prior to the formation of the TSX Venture Exchange. Note that the return correlation increases more or less consistently as we look at higher quintiles, which suggests that trading activity plays an important and constructive role in linking markets. The highest return correlation is for quintile 5 stocks in each market, and equals 0.60, indicating a more than moderate level of return co-movement.

Panel C shows that the return correlation increases dramatically for all volume quintiles in the year immediately after the formation of the TSX Venture Exchange. This suggests that the markets became more closely integrated in the immediate aftermath of the formation of the TSX Venture Exchange (whether or not this was sustained over longer periods is answered in the subsequent panels). For all but the lowest quintile, the post-TSX Venture Exchange formation period is marked by moderate to high return correlations, ranging from 0.41 for quintile 2 to 0.83 for quintile 5. By contrast, in the pre-TSX Venture Exchange period, the corresponding correlations range from 0.20 for quintile 2 to 0.60 for quintile 5. Note that, as in the pre TSX Venture period, the cross-market correlations increase steadily with volume. The high cross-market correlations for the top two volume quintiles are consistent with the more actively traded stocks having a wider national investor base after the formation of the TSX Venture Exchange. That is, these stocks are likely to have attracted inter-provincial investors even before the formation of the TSX Venture Exchange, but the number of such investors swells following the introduction of a national small cap market.

One interpretation of these results is that the formation of the TSX Venture Exchange brought about economically significant increases in cross-market integration. But we caution that the analysis of a longer period is necessary to confirm this conclusion. Accordingly, the remaining panels of Table 4 present return correlations for 12-month periods starting two years before, and one and two years after, the formation of the TSX Venture Exchange. These results

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[15] Price also serves as a proxy for market capitalization, for which data are not available. It is typically the case that stocks with smaller market caps have lower prices.

suggest some caution in interpreting the correlation-based evidence. In particular, the level of the correlations fluctuates across years. For instance, the correlations in Panel A (two years before through one year before the formation of the TSX Venture Exchange) are similar to the corresponding levels in panel C (except for the top two quintiles), and the increase in Panel D is more modest compared to Panel B. We believe, however, that a comparison of correlations across adjacent years is reasonable, and provides the best evidence regarding the short-term impact of the merger. Correlations over longer-horizons, while providing evidence on the sustainability of co-movement, are plagued by more noise due to the possibility of significant changes in the ownership or trading environment over longer periods, and hence more difficult to ascribe to the merger event.

The large increase in the correlations in the year following the formation of the TSX Venture Exchange indicates that these 12 months were somewhat unusual, possibly due to a realignment of investors across the two markets. Once this had stabilized, the return correlations reverted to more modest levels. Recall from section 5(a)(i) that the market-level return correlation two years following the formation of the TSX Venture Exchange is identical (0.66) to the correlation in the prior period.

We also provide a graphical illustration of co-movement by plotting the cumulative returns for corresponding volume quintiles in the two markets. For example, Figure 2A plots the cumulative daily returns for stocks from the lowest volume quintile on the TSX and the TSX Venture Exchange. Figure 2B through Figure 2E display the cumulative returns for the remaining four volume quintiles from both markets. In all cases we see that, although the decline for the TSX Venture Exchange portfolio is steeper than the decline for the TSX portfolio, the two series track each other reasonably closely. Overall these results paint a picture of markets that display moderate levels of integration in terms of returns, especially in more recent years.

(iii) Return Correlations for Price Categories

We now turn to an examination of return co-movement for stocks in different price categories. As stated earlier, we are concerned that low priced stocks, particularly those that trade at prices below $1, might have a differential and potentially large impact on the return correlations. In Table 5 we provide the correlations between equally-weighted indexes formed from TSX and TSX Venture Exchange stocks divided into three price categories. In the year prior to the formation of the TSX Venture Exchange (Panel B), the low and medium price portfolios in the two markets display moderate return correlations (0.61 or less) while the correlation is lowest for the highest price portfolios (0.28).

In the year following the formation of the TSX Venture Exchange (Panel C), there is a large increase in the correlation of returns for the matching price portfolios (e.g. to 0.79 for the lowest priced stocks and to 0.65 for the highest priced stocks). Again, this comparison of the two years surrounding the formation of the TSX Venture Exchange indicates that this event has increased the extent to which the regional market and the TSX are integrated. While the correlations decline in the second year following the formation of the TSX Venture Exchange (Panel D), the increase in the correlation appears to be sustained for the low and mid price

portfolios, though not for the highest price stocks. Panel A shows surprisingly large correlations two years before the formation of the TSX Venture Exchange, and Panel E shows a slight decline in integration in the year 2001-2002 relative to the previous year.

Curiously, the level of the correlation declines with price in every period. We suspect this is driven by the small sample size of high priced stocks on the TSX Venture Exchange (see Tables 1 and 2). A second, more intriguing possibility, and one consistent with partial segmentation, is that institutional investors are constrained to invest in higher priced stocks, and that there exists a local geographical bias in institutional investment.[16] To the extent that low price stocks are dominated by retail investors, a similar argument suggests that the large correlations for the low price portfolios could be driven by geographically correlated retail investor sentiment.

(b) *Volume Co-movement*

Our examination of volume co-movement provides evidence on market integration beyond that provided by the foregoing analysis of return co-movement. This is because a high volume correlation indicates that trading decisions are correlated across markets, irrespective of the price effects of the trades themselves. For instance, assuming that the TSX and the TSX Venture Exchange are well-integrated, investors (taken together) will often buy stocks trading on the TSX and sell stocks on the TSX Venture Exchange. This might drive returns in opposite directions, and will lower the extent to which returns co-move in the same direction; however, the volume correlation will be large even in these circumstances. Integrated trading implies that, as with returns, volume will display strong cross-market correlations, while fragmented trading implies that the volume correlations will be low.

We first examine the extent of co-movement in mean trading volume for all stocks trading on the TSX and all stocks trading on the TSX Venture Exchange (see also Figure 1, panel C). The volume correlation in the year prior to the formation of the TSX Venture Exchange is 0.57, indicative of moderately integrated markets. Following the formation of the TSX Venture Exchange, the correlation increases to 0.78, indicating a strengthening of the degree of integration. When we widen the window of inquiry, we see similar patterns to those for returns. Specifically, the volume correlation declines two and three years after the formation of the TSX Venture Exchange. With volume, however, the correlation remains appreciably above its pre-TSX Venture Exchange levels. For instance, the correlation two years after the formation of the TSX Venture Exchange is 0.40 compared to 0.30 two years before this event.

In order to get a deeper view of integration, we calculate the correlations in mean volume for the TSX and TSX Venture Exchange trading volume quintiles. The results are provided in Table 6. As before, we focus on the two years centred on the formation of the TSX Venture Exchange (Panels B and C). Panel B shows that the volume correlation ranges from 0.22 for quintile 1 to 0.55 for the most actively traded quintile in the pre-TSX Venture Exchange period. In Panel C, we find that each of these correlations gets stronger following the formation of the TSX venture exchange, with values ranging from 0.44 for quintile 1 to 0.75 for quintile 4.

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[16] See, for instance, Coval and Moskowitz (2003a, b).

So far, the volume results parallel the return results, suggesting first, that the equity markets displayed a low to moderate degree of integration of trading prior to the formation of the TSX Venture Exchange; and second, that following this event, trading patterns in the two markets became significantly more correlated. Examining volume co-movement one year after the formation of the TSX Venture Exchange, we see that the volume correlation declines to its pre-event level for every quintile pair. Note that the low volume quintiles generally exhibit lower cross-market correlations than quintiles containing more actively traded stocks, possibly due to thin trading *per se*, or to higher transaction costs for thinly traded stocks.

Figure 4 provides a plot of average daily trading volume per stock for the TSX and TSX Venture Exchange quintiles. Our interest here is in how closely the two series track each other. While it is clear that for each quintile pair, average trading volume is greater for the TSX quintile than for the corresponding TSX Venture Exchange quintile, the two series exhibit coincident ups and downs in trading activity, confirming the correlation evidence presented above.

Table 7 and Figure 5 provide evidence on the volume correlations for the three price categories. Table 7 shows a jump in the volume correlations in the year following the formation of the TSX Venture Exchange relative to the preceding year, and for the lower priced stocks in particular. The weaker results for the high-priced stocks are due, at least in part, to the small number of TSX Venture Exchange stocks with high prices. Figure 5 provides similar plots for mean daily volume in the three price groupings on the TSX and the TSX Venture Exchange. These plots show that low and medium priced stocks on the TSX and the TSX Venture Exchange exhibit strong co-movement, but high priced stocks show less of an association.

We have mentioned the limitations of comparing the correlations across widely-spaced years. Keeping that caveat in mind, our results can be summarized as follows: Overall, the return and volume correlations, for all stocks and separately for the price and volume portfolios, paint a picture of equity markets that are moderately integrated immediately prior to the formation of the TSX Venture Exchange and are more strongly integrated immediately following the formation of the TSX Venture Exchange.[17]

6. Merger Event Study: Analysis of the Formation of the TSX Venture Exchange

The merger of the ASE and the VSE in November 1999 led to the creation of the TSX Venture Exchange as the primary venue for trading junior equities in Canada. As discussed in Section 2, the formation of the TSX Venture Exchange provides a natural experiment to study

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[17] We also compute within-market correlations for the volume and price portfolios, e.g. for volume quintile 1 and volume quintile 5 on the TSX (and similarly on the TSX Venture Exchange). The within-market correlations display similar overall trends to the cross-market numbers provided in the tables. Generally, the increases in the correlations between markets are similar to those within markets, with the increases in the within TSX Venture Exchange correlations being slightly larger, and those for the TSX somewhat lower, than the increases in the TSX Venture–TSX correlations. It is possible that other factors besides the merger are driving the patterns in the return and volume correlations (e.g. more comprehensive computer systems to trade stocks Canada-wide). However, these factors seem to have had similar effects on all of the correlations. In other words, integration is increasing both within and across markets. Since our mandate is to analyze the degree of market fragmentation, our focus is on the cross-market correlations.

the effects of harmonized regulations and scale economies in regulation. Specifically, the merger of the ASE and the VSE resulted in a common set of rules governing trading at the two exchanges. While this falls short of a uniform set of securities regulation and common regulators, the limited harmonization offers a microcosm of what larger scale regulatory harmonization might bring.

To shed light on these effects, we carry out an *event study* of the formation of the TSX Venture Exchange. The previous section provided aggregate results that might obfuscate stock level findings associated with the merger. Our goal is to study the effects of the harmonization on both the market quality of the ASE and VSE and the degree of integration of the ASE and the VSE. We begin by calculating the mean stock price, relative spread, trading volume and volatility for the intervals November 1, 1998 through October 31, 1999 (for brevity, year –1 relative to the formation of the TSX Venture Exchange); January 1, 2000 through December 31, 2000; and January 1, 2001 though December 31, 2001 (years +1 and +2). The three intervals represent one year before and two consecutive years after the formation of the TSX Venture Exchange (as before, we exclude the month on either side of the event, to avoid transition-related effects). Improvements in market quality will be reflected in a higher average price and volume, and a lower relative spread and volatility.

Accordingly, we calculate the difference between the average value for each variable in year +1 and year +2 relative to year –1. This calculation proceeds in two steps. First, we calculate the average price (for instance) for each stock on the TSX Venture Exchange in calendar year 2000 (year +1) and also for the period November 1, 1998-October 31, 1999 (year –1) and subtract the average price for year –1 for each stock from its year +1 average. In the second stage, we calculate the cross-sectional median of the stock-by-stock differences, and report the median in the table. We proceed similarly with trading volume, volatility and the relative spread. Due to the problems associated with comparisons across stocks with differing levels of prices and volumes, we calculate and summarize the percentage change in mean price and mean volume for each stock. Also, in order to control for market-wide effects, we calculate similar differences for all TSX firms, which provide a benchmark for the TSX Venture Exchange formation effects. This analysis is carried out for ASE and VSE firms that survive on the TSX Venture Exchange. However, we do not impose the condition that the firms be listed for the entire calendar year 2000.[18]

Table 8 describes these results. We separately report the results for all ASE and VSE stocks, though (in order to save space) not for the price or volume categories. The price of the median ASE (VSE) stock is higher by 18% (11%) in year +1 relative to year –1, compared to an increase of 3% for the median TSX stock. Trading volume increases by 51% in year +1 for VSE stocks and by 28.3% for the TSX. Surprisingly, volume decreases by 32% for ASE stocks; however, it is notable that this reduction is substantially smaller than the increase for VSE stocks, so that the net effect is increased trading volume on the TSX Venture Exchange. The relative spread declines in year +1 for both ASE and VSE stocks (and by more for the former, despite the reduction in volume), though not for TSX stocks. Finally, volatility increases on

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18 We wish to mitigate the effects of survivorship bias, which could, for instance, inflate the measured price differential. See for instance, Kothari, Shanken and Sloan (1995). We do, however, impose the condition that a minimum of 30 observations be available.

both the VSE and the TSX, though not on the ASE. The increase for VSE stocks is more than twice as large as that for TSX stocks. Overall, with the exception of the volume results for the ASE and the volatility results for the VSE, the formation of the TSX Venture Exchange appears to have had a favourable effect on market quality.

We examine a longer window to confirm the price effect. When we compare prices from year +2 to year –1 we find that the price effect is large and negative for the TSX Venture Exchange (-37% for the VSE and -17% for the ASE) relative to the TSX (-7%). This is also a substantial reduction in volume for the VSE and especially the ASE, and a large increase in trading costs for ASE and VSE stocks (the volatility results are mixed). We suspect these results are unrelated to the formation of the TSX Venture Exchange for two reasons. First, the immediate effect of the merger on prices and volume is generally positive, and the further out one goes from the event, the greater the noise associated with drawing conclusions. Second, the market decline during this period, particularly the precipitous drop in the value of tech and small cap stocks, is likely associated with these price changes for stocks listed on the TSX Venture Exchange. A longer-term examination as well as comparisons across industries might provide useful insights. These tasks are left to future work.

The effects of the TSX Venture Exchange formation on integration are summarized in Table 9 through Table 12. These results parallel those in Section 5, with Tables 9 and 10 providing the correlations for volume and price portfolios formed from ASE and VSE stocks, and Tables 11 and 12 the corresponding volume correlations.

These results can be summarized as follows. First, our untabulated results for the entire set of stocks from the ASE and VSE show a significant jump in the cross-market correlation associated with the formation of the TSX Venture Exchange. Specifically, the return correlation increases from 0.57 to 0.88 between years –1 and +1, while the volume correlation increases from 0.52 to 0.93. Second, a similar increase is seen for the volume and price portfolios, with the largest increases occurring for the highest volume and low price stocks (quintiles 4 and 5 and price portfolio 1). Third, the increase in the volume correlations is more pronounced than the rise in the return correlations, reflecting greater synchronicity of trading decisions with the formation of a single exchange.[19]

In sum, the event study results point to a favourable impact of harmonized regulations on trading in secondary markets. Previously separate markets appear to move together to a greater extent following the partial merger of their rulebooks. Also, the merger seems to have lifted prices and volumes (for the most part), and lowered trading costs. Given the market-wide decline in equity values in 2000, however, we are unable to say whether the beneficial short-term effects of harmonized trading rules on market quality are sustainable.

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[19] As with the correlations in Section 5, the ASE-VSE correlations both are volatile and decline following year +1. We focus our discussion on the effects in years -1 and +1 but present the entire set of correlations.

7. Implication of the Analysis for Securities Regulatory Reform

The ASE, VSE, TSX Venture Exchange and TSX data analyzed in this paper yield the following important results. First, we document increases in trading volume for VSE-listed stocks (though not ASE-listed stocks) after the formation of the TSX Venture Exchange. The formation of the TSX Venture Exchange brought about regulatory changes that lowered the uniqueness of the ASE and VSE and made them part of a national market. While we are puzzled by the ASE results, it is worth noting that the decline for ASE stocks is substantially lower than the increase for VSE stocks. The most plausible explanation for the increased trading volume is increased interest in, and ownership of, TSX Venture Exchange companies by residents in different jurisdictions in Canada in the post-TSX Venture Exchange period. Our correlation analysis confirms this interpretation. Thus, the formation of a single market appears to promote nation-wide interest in the constituent stocks.

Second, we compute the correlations between returns and volume for the ASE and the VSE and the TSX, and then for the TSX Venture Exchange and the TSX and find that the correlations and, therefore, the extent of equity market integration, have fluctuated through time. However, integration was at impressive levels as long as five years ago. In fact, the return correlations were higher in 1997 than in 2002. The large correlations suggest that the TSX Venture Exchange and the TSX have been relatively well-integrated for some time, and that market participants on the TSX and TSX Venture Exchange are homogenous. This result, in turn, suggests that there were no barriers to investors trading in regional markets despite the lack of uniform regulations. In other words, a moderately high level of integration was achieved even prior to the creation of the TSX Venture Exchange (which, as shown elsewhere in this study, further reinforced integration).

Third, our findings speak to an issue that is often overlooked in the analysis of securities regulation in Canada. The issue is whether regional differences in economic activity give rise to differences in regulatory structures across provinces, or differences in regulatory structures give rise to differences in economic activity across provinces. Our analysis compares the correlation in stock returns for the ASE and the VSE both before and after the formation of the TSX Venture Exchange, which was associated with a significant harmonization of regulations and regulators for the exchanges, at least across the provinces of Alberta and British Columbia. The correlation for ASE and VSE returns and volume increased immediately after the formation of the TSX Venture Exchange, suggesting that a unified regulatory structure might promote integration. However, a longer-term comparison of the correlations suggests that these beneficial effects are most pronounced in the year following the merger, and revert to pre-merger levels by the end of the second year following the event.

Finally, we document differences in average price levels, trading activity and trading costs between the TSX Venture Exchange and the TSX. However, there are also striking similarities across markets, notably, the large fractions of low price and thinly traded stocks in both markets. Approximately one in three stocks on the TSX trades at a price less than one dollar – one normally does not associate "penny stocks" with the TSX, the senior stock market in Canada. Similarly, we find that many stocks, not only on the TSX Venture Exchange, but also on the TSX, are thinly traded. We find that returns and volume co-move strongly for low-priced

stocks on the TSX Venture Exchange and the TSX, for high-priced stocks at the two venues, and for actively- and thinly traded stocks. The fact that returns and volume co-move for stocks with similar attributes but trading in different markets suggests that these stocks might benefit from similar Canada-wide regulation.

Overall, our conclusions are that the regional equity markets in Canada are well integrated with one another, and that prices and trading activity in regional markets co-move to a significant degree even after controlling for firm-specific characteristics such as price and volume. These findings call into question sector-specific regulations across the regional markets: after all, when thinly-traded stocks on the TSX Venture Exchange co-move with thinly-traded stocks on the TSX, it is difficult to argue that each market needs idiosyncratic regulation. Instead, we suggest a regulatory model based on trading volume or price levels (or, by extension, firm size) that would remain the same across provincial boundaries.

8. Comparison with Approaches Studying Issuer Characteristics

The discussion and analysis of regional and sectoral differences in Canadian markets typically focuses on the characteristics of firms in different provinces and/or the different components of general economic activity in different provinces. It is likely that a primary reason for the focus on characteristics of firms in different locations is that investor location data do not exist for publicly traded companies on Canada's stock exchanges. For the purpose of designing an appropriate securities regulatory structure for Canada, however, this type of analysis is incomplete for a number of reasons. For example, it fails to account for the fact that the same firm may have operations in different provinces. It also fails to account for the fact that a firm's suppliers of capital may not be located in the same province as that in which the firm is based. If companies are owned by investors in several provinces, the need for different securities regulatory structures in different regions of Canada is significantly weakened, and any documented differences in economic activity in different regions are not necessarily relevant for the purpose of redesigning securities regulation in Canada.[20]

Briefly, there are many reasons why investors should be the primary focus when analyzing market fragmentation and securities regulatory reform and the debate on jurisdiction or sector specific securities laws. First, many investors, particularly those investors in publicly traded companies, will not reside in the same jurisdiction as the firm in which they invest. Second, investors tend to hold diversified portfolios of companies from different industries. Third, fragmented regulation and regulators increase regulatory uncertainty and compliance costs, exacerbate the differences in the type of information provided to market participants by different firms, and therefore increase the costs of firm diversification across jurisdictions that are regulated differently. Fourth, given the third point, fragmented regulation lowers liquidity, which in turn increases the cost of capital (required rate of return) for firms. Similarly, regulatory fragmentation increases bid-ask spreads. Fifth, fragmented regulation directly increases the costs of litigation for investors when there is in fact an issue involving litigation.

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[20] The differences are nevertheless of potential factual interest. Some differences in the characteristics of reporting issuers by province, GDP activity, among other things, are provided in a descriptive analysis by Puri (2003).

Sixth, the very reason for securities regulation is for the purpose of investor protection, which is seriously undermined in light of issues #1-5.

In view of these issues, we believe that an analysis of investor behaviour across regional equity markets is central to the study of securities regulatory reform in Canada. The findings in this paper contribute to the core of the debate on integration versus fragmentation in Canada's public equity markets. We hope to shift the debate on the economics of securities regulation away from regional and sectoral analyses of firms, and toward the recognition that integration involves not only firms but also, more importantly, investors and trading outcomes. Securities regulation is about the twin objectives of investor protection and market efficiency. Clearly, companies stand to benefit from a reduced cost of capital when the interests of investors as capital contributors are upheld.

9. Conclusion

In the debate on Canadian securities markets regulation, academic and practitioner reports on regional and sectoral fragmentation in Canadian stock markets typically focus on the characteristics of reporting issuers and/or economic activity in different provinces. Such analysis provides little guidance as to the appropriate securities regulatory structure for publicly listed Canadian companies. As we have explained, even if there are differences in the types of companies located in different provinces, publicly listed companies may have investors that are widely dispersed across Canada. This alone reduces the benefits of disparate regulation.

The tendency to focus on characteristics of firms in different locations is likely to be driven by the fact that investor location data for publicly traded companies on Canada's stock exchanges do not exist. In our companion paper (Cumming, Kaul and Mehrotra, 2003a), we analyze private equity data that match the provinces of location of the investor and investee. Unfortunately, such location data are unique to Canada's private equity markets.

Although ownership and investor location data do not exist for publicly traded companies in Canada, one can nevertheless ascertain the degree of integration/fragmentation in Canadian markets through an empirical analysis of prices, volatility, bid-ask spreads, trading volume, and return/volume co-movement for stocks listed on the different exchanges. This paper addresses these measures of integration. Importantly, we focus on the correlations in prices and volume across the ASE/VSE, the TSX Venture Exchange and the TSX, and compare these correlations in the pre- and post-TSX Venture Exchange formation periods, as well across stocks with different prices and trading volumes.

Our main findings were as follows. First, we document increases in trading volume for VSE-listed stocks (though not the ASE-listed stocks) after the formation of the TSX Venture Exchange. The formation of the TSX Venture Exchange brought about regulatory changes that lowered the uniqueness of the ASE and VSE and made them part of a national market. While we are puzzled by the ASE results, it is notable that the decline in volume for ASE stocks is substantially lower than the increase for VSE stocks. The most plausible explanation for the increased trading volume is increased interest in, and ownership of, VSE companies by residents

in different jurisdictions in Canada in the post-TSX Venture Exchange period. Our correlation figures (discussed below) confirm this interpretation.

Second, we compute the correlations between returns and volume for the ASE and the VSE and the TSX, and then for the TSX Venture Exchange and the TSX and find that the correlations and, therefore, the extent of equity market integration have fluctuated through time. However, integration was at impressive levels as long as five years ago. The large correlations suggest that the TSX Venture Exchange and the TSX have been relatively well-integrated for some time, and that market participants on the TSX and TSX Venture Exchange are homogenous.

Third, our findings speak to an issue that is often overlooked in the analysis of securities regulation in Canada. The issue is the following: do regional differences in economic activity give rise to differences in regulatory structures across provinces, or do differences in regulatory structures give rise to differences in economic activity across provinces. Our analysis compares the correlation in stock returns for the ASE and the VSE both before and after the formation of the TSX Venture Exchange, which was associated with a significant harmonization of regulations and regulators for the exchanges, at least across the provinces of Alberta and British Columbia. The correlation between the ASE and the VSE increased in the year following the formation of the TSX Venture Exchange, suggesting that a unified regulatory structure promotes integration, although these effects got weaker over longer intervals.

Finally, we document differences in average price levels, trading activity and trading costs between the TSX Venture Exchange and the TSX. However, there are also striking similarities across markets, notably, the large fractions of low priced and thinly traded stocks in both markets. Approximately one in three stocks on the TSX trades at a price less than one dollar – one normally does not associate "penny stocks" with the TSX, the senior stock market in Canada. Similarly, we find that many stocks, not only on the TSX Venture Exchange, but also on the TSX, are thinly traded. We find that returns and volume co-move strongly for low-priced stocks on the TSX Venture Exchange and the TSX, for high-priced stocks at the two venues, and for actively- and thinly traded stocks.

Overall, our conclusions are that the regional equity markets in Canada are well integrated, and that prices and trading activity in regional markets co-move to a significant degree even after controlling for firm-specific characteristics such as price and volume. These findings call into question sector-specific regulations across the regional markets: after all, when thinly-traded stocks on the TSX Venture Exchange co-move with thinly-traded stocks on the TSX, it is difficult to argue that each market needs idiosyncratic regulation. Instead, we suggest a regulatory model based on trading volume or price levels (or, by extension, firm size) that would remain the same across provincial boundaries.

Appendix I
Robustness Tests

This appendix describes the results of additional tests to confirm the robustness of our earlier results in Section 5 and Section 6. First, while we show that stock prices increase slightly and relative spreads decline sharply following the formation of the TSX Venture Exchange, we also show that trading volume increases substantially (see Table 2 and Section 6). Thus, an alternative explanation for our results is that increased trading volume leads to lower relative spreads and hence to higher prices (Amihud and Mendelson (1986) were the first to document a relation between trading costs and prices; see also Brennan and Subrahmanyam (1995)).

In order to address this possibility, we run the following time-series regressions between a stock's relative spread or its price and trading volume:

$$\mathrm{Re}lspr_t = \alpha + \delta Dum_{TSE-V} + \beta Volume_t + \varepsilon_t \text{ and}$$
$$\frac{1}{P_t} = \alpha + \delta Dum_{TSE-V} + \beta Volume_t + \varepsilon_t$$

Here, $Dum_{TSE\text{-}V}$ is a dummy variable that is one after the formation of the TSX Venture Exchange and zero beforehand, $Volume_t$ is daily volume on day t and $Relspr_t$ and $Price_t$ are the relative spread and closing price for day t. We choose to run the regression for price in terms of its inverse in order to minimize potential problems associated with the non-stationarity of prices. We estimate this regression for each stock that is listed on the ASE (or VSE) and the TSX Venture Exchange and report the mean coefficients in Panel A of Table 13.

In interpreting these numbers, note that the mean post-TSX Venture Exchange effect for each stock is given by $\alpha+\delta$ and the mean pre-TSX Venture Exchange effect is given by α. Thus, if increased trading volume explains the higher price or lower relative spread, the coefficient δ should be insignificantly different from zero. On the other hand, if the change in the mean price or relative spread remains favourable after accounting for volume, δ will be negative in both regressions (recall that we examine the relation between volume and the inverse of price; hence an improvement in price is signified by a negative value of δ).

For each variable (price and relative spread) we separate ASE, VSE and TSX stocks (the latter is included as a benchmark). Coefficients in boldface are significant at the 5% level of significance. The mean values of the intercept and the coefficients on the dummy variable and volume are significantly different from zero for stocks trading on the TSX Venture Exchange as well as on the TSX. Most importantly, for ASE and VSE stocks, the coefficient on the dummy variable is significantly negative in the regressions for the relative spread and price even after we control for volume. Thus, the improvement in prices and relative spreads following the formation of the TSX Venture Exchange cannot be attributed to the increased volume (at least for VSE stocks) that accompanied its formation.

To benchmark these effects, we repeat the regression for TSX stocks. While the value of δ in the relative spread regression is appreciably smaller than the values for the ASE and VSE, it is *positive* and insignificantly different from zero in the price regression. Thus, relative to TSX stocks, there is a larger abnormal decline in the spreads for venture stocks, and a larger abnormal increase in their prices. It is worth noting that the smaller intercepts for TSX stocks suggest higher TSX prices and lower relative spreads compared to TSX Venture Exchange stocks. This is reassuring because it is consistent with the descriptive statistics in Table 2.

As a specification check, the lower panel of Table 13 provides a similar regression, but estimated cross-sectionally. Here, for each market (ASE, VSE, TSX), we regress the change in the average relative spread or in the average price between the year after and the year before the formation of the TSX Venture Exchange on the corresponding change in average trading volume:

$$\overline{S}_{postTSX-V} - \overline{S}_{preTSX-V} = \alpha + \beta(\overline{V}_{postTSX-V} - \overline{V}_{preTSX-V}) + \varepsilon_t \text{ and}$$
$$\overline{P}_{postTSX-V} - \overline{P}_{preTSX-V} = \alpha + \beta(\overline{V}_{postTSX-V} - \overline{V}_{preTSX-V}) + \varepsilon_t$$

where S is the relative spread, P is the stock price and V is volume, and the bar above each variable indicates that this is the mean value for each stock over the period shown in the subscript. In this specification, α represents the mean change in the price or relative spread associated with the formation of the TSX Venture Exchange for the sample of ASE or VSE stocks. If, controlling for volume, the event is associated with a lower mean relative spread and a higher mean price, α will be negative in the spread regression and positive in the price regression. As shown in Panel B of Table 13, there is general support for this conclusion.

The coefficient on volume is negative in the regression for relative spreads, and this is consistent with the fact that more heavily-traded stocks have lower relative spreads. The matching coefficient in the price regression is positive (though not always significant), indicating that stocks that experience larger volume increases see their prices rise more sharply. Both of these observations are consistent with existing microstructure research (see Harris, 2002, for a good summary). It is seen that the intercept in the price regression is positive but not significantly different from zero for either the ASE or the VSE. Thus, cross-sectional differences in changes in volume appear to explain the mean price increase around the formation of the TSX Venture Exchange.

By contrast, the intercept in the relative spread regression remains reliably below zero for both the ASE and the VSE, indicating that mean relative spread declines in the post-TSX Venture Exchange period, even after controlling for volume changes. The corresponding regressions for TSX stocks indicate a larger mean price increase and similar declines in the mean spread, relative to the TSX Venture Exchange. Overall, the earlier conclusions from the event study analysis remain unchanged.

A second and somewhat related concern is that the volume quintiles are non-comparable through time. Specifically, since trading activity has increased through time, a particular quintile consists of stocks that trade more actively in the post-TSX Venture Exchange period relative to the pre-TSX Venture Exchange period. In order to deal with this concern we replicate our results holding the definition of the quintile breakpoints fixed. In other words, we form quintiles on the basis of trading volume over the year preceding the formation of the TSX Venture Exchange and then define the volume quintiles in the post-TSX Venture Exchange period using the same volume cutoffs as in the pre-TSX Venture Exchange period. Our conclusions are identical when we fix the breakpoints.

Third, a possible concern is that, by considering every stock on each exchange, we have allowed the composition of the indexes to change. We address this concern by restricting the TSX Venture Exchange portfolios to stocks that were also listed on the ASE and VSE. Our results and conclusions are similar to those reported in the paper.

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Table 1
The Number of Stocks Trading during Each Year, 1997-2002

The table presents the total number of listed firms, the number of firms with positive prices, and their breakdown between three price categories for the Vancouver Stock Exchange and the Alberta Stock Exchange (1997-1998), the TSX-Venture Exchange (1999-2002) and the TSX (1997-2002) on the last trading day in the year. Price categories 1, 2 and 3 consist of stocks with prices $P < \$1$, $\$1 \leq P < \$5$, and $P \geq \$5$ on the last day of the year. For 1997 and 1998, the Vancouver data are presented in the first row and the Alberta data in the second row.

Year	**VSE/TSX-Venture**				
	Total # stocks	# stocks with valid prices	# stocks pr_cat1	# stocks pr_cat2	# stocks pr_cat3
1997	1705	1406	1191	192	23
	1165	1157	892	218	47
1998	1705	1474	1323	112	39
	1199	1192	1013	144	35
1999	2132	2027	1750	238	39
2000	2926	2745	2409	290	46
2001	2986	2677	2479	172	26
2002	3186	2880	2698	163	19
Year	**TSX**				
	Total # stocks	# stocks with valid prices	# stocks pr_cat1	# stocks pr_cat2	# stocks pr_cat3
1997	1417	1322	294	394	634
1998	1426	1316	391	342	583
1999	1465	1363	359	376	628
2000	1465	1329	367	364	598
2001	1397	1254	347	346	561
2002	1287	1180	317	339	524

Table 2A

TSX Venture Exchange Market Quality

The median price, volume, volatility and spread on the TSX Venture Exchange. *Before* refers to the period November 1, 1998 through October 31, 1999, for which the market is the composite of the Alberta and Vancouver Stock Exchanges. *After* refers to the period January 1, 2000 through December 31, 2000, for which the market is the TSX Venture Exchange. Volatility is the absolute value of the daily return, Relative Spread is calculated as the bid-ask spread normalized by the stock price. Price categories 1, 2 and 3 consist of stocks with median prices $P < \$1$, $\$1 \leq P < \$5$, and $P \geq \$5$. Volume quintile 1 consists of the stocks with the lowest trading volume and quintile 5 of stocks with the highest volume.

	All Stocks	Price Cat_1	Price Cat_2	Price Cat_3	Volume Quintile_1	Volume Quintile_2	Volume Quintile_3	Volume Quintile_4	Volume Quintile_5
Price Before	0.24	0.20	1.67	19.88	0.27	0.20	0.23	0.25	0.27
Price After	0.32	0.25	1.72	12.92	0.27	0.27	0.27	0.31	0.38
Volatility Before	0.055	0.058	0.044	0.030	0.031	0.045	0.056	0.055	0.063
Volatility After	0.047	0.047	0.049	0.032	0.019	0.032	0.048	0.062	0.073
Rel Spread Before	0.22	0.23	0.08	0.08	0.28	0.26	0.23	0.20	0.13
Rel Spread After	0.21	0.23	0.08	0.08	0.29	0.25	0.21	0.17	0.12
Volume Before	10547	10755	9094	5893	1464	4595	9084	15354	40828
Volume After	8916	8246	14693	2294	495	2345	6075	15697	63020

Table 2B
TSX Market Quality

The median price, volume, volatility and spread on the TSX. *Before* refers to the period November 1, 1998 through October 31, 1999. *After* refers to the period January 1, 2000 through December 31, 2000. Volatility is the absolute value of the daily return, Relative Spread is calculated as the bid-ask spread normalized by the stock price. Price categories 1, 2 and 3 consist of stocks with median prices $P < \$1$, $\$1 \leq P < \$5$, and $P \geq \$5$. Volume quintile 1 consists of the stocks with the lowest trading volume and quintile 5 of stocks with the highest volume.

	All Stocks	Price Cat_1	Price Cat_2	Price Cat_3	Volume Quintile_1	Volume Quintile_2	Volume Quintile_3	Volume Quintile_4	Volume Quintile_5
Price Before	3.86	0.38	2.34	15.65	4.55	2.80	2.31	2.76	4.40
Price After	4.57	0.42	2.41	16.03	4.65	2.96	2.77	3.34	6.28
Volatility Before	0.026	0.052	0.029	0.017	0.018	0.026	0.030	0.031	0.031
Volatility After	0.030	0.056	0.033	0.021	0.021	0.031	0.034	0.035	0.037
Rel Spread Before	0.04	0.12	0.05	0.02	0.08	0.06	0.05	0.03	0.02
Rel Spread After	0.04	0.10	0.04	0.02	0.07	0.06	0.04	0.03	0.02
Volume Before	20166	22446	15755	21276	798	4728	14955	44320	160574
Volume After	29975	28204	23880	36924	1378	7433	22208	59546	217254

Table 2C
TSX Venture Exchange and TSX Variance Ratio Tests

For each stock, a variance ratio is calculated as the ratio of the weekly return variance to five times the daily return variance. The table presents the cross-sectional median of the distribution of the variance ratio less 1.0 for the TSX and the TSX Venture Exchange, which is the composite of the Alberta and Vancouver Stock Exchanges before November 1999. *Before* refers to the period November 1, 1998 through October 31, 1999. *After* refers to the period January 1, 2000 through December 31, 2000. Price categories 1, 2 and 3 consist of stocks with median prices $P < \$1$, $\$1 \leq P < \$5$, and $P \geq \$5$. Volume quintile 1 consists of the stocks with the lowest trading volume and quintile 5 of stocks with the highest volume.

	All Stocks	Price Cat_1	Price Cat_2	Price Cat_3	Volume Quintile_1	Volume Quintile_2	Volume Quintile_3	Volume Quintile_4	Volume Quintile_5
TSX Venture									
Variance Ratio Before	-0.2086	-0.1927	-0.3375	-0.0839	1.1260	0.1697	-0.1975	-0.2985	-0.3638
Variance Ratio After	-0.1857	-0.1759	-0.2575	-0.0288	0.5804	0.1143	-0.1350	-0.3309	-0.3462
TSX									
Variance Ratio Before	-0.2456	-0.3723	-0.2829	-0.1304	-0.0347	-0.1115	-0.0948	-0.0023	0.0049
Variance Ratio After	-0.2721	-0.4293	-0.3410	-0.1647	-0.2034	-0.3101	-0.1420	0.0321	0.0279

Table 3

The Cross-Section of Stock Prices and Volumes on the First Trading Day in November, 1997-2002

The table presents the percentage of firms in three price and seven volume categories and the total number of firms on the TSX Venture Exchange and the TSX on the first trading day in November of the years, 1997-2002. Before the year 2000, the TSX Venture Exchange is the composite of the Alberta and Vancouver Stock Exchanges. Price categories 1, 2 and 3 consist of stocks with prices $P < \$1$, $\$1 \leq P < \$5$, and $P \geq \$5$. The seven categories for volume on the day in question are: $Vol = 0$; $0 \leq Vol < 1{,}000$; $1{,}000 \leq Vol < 10{,}000$; $10{,}000 \leq Vol < 100{,}000$; $100{,}000 \leq Vol < 500{,}000$; $500{,}000 \leq Vol < 1{,}000{,}000$; and $Vol \geq 1{,}000{,}000$. Note that the total number of firms for all price and all volume categories is not equal due to some stocks having missing prices or volumes for the day in question.

TSX-V

Year	Price category				Volume category							
	1	2	3	Num firms	1	2	3	4	5	6	7	Num firms
1997	78.1	19.9	2.0	1724	40.8	26.0	15.7	15.4	1.6	0.3	0.2	1971
1998	89.8	9.4	0.9	1519	46.2	3.7	22.8	24.1	2.5	0.3	0.3	1551
1999	87.8	10.8	1.4	1488	39.4	6.9	25.1	25.5	3.0	0.3	0.1	1560
2000	87.3	11.8	1.0	2157	50.9	4.3	20.2	21.4	3.0	0.2	0.1	2233
2001	94.5	5.0	0.5	2237	63.4	3.8	13.5	16.6	2.4	0.2	0.0	2341
2002	94.9	4.6	0.6	2060	62.0	5.0	13.2	16.9	2.7	0.2	0.1	2185

TSX

Year	Price category				Volume category							
	1	2	3	Num firms	1	2	3	4	5	6	7	Num firms
1997	19.4	30.1	50.5	1240	20.7	7.7	24.3	33.5	10.8	2.2	0.9	1278
1998	28.5	27.9	43.6	1272	24.2	7.5	23.3	29.8	11.5	1.8	1.9	1291
1999	27.2	28.7	44.1	1237	21.7	7.9	28.8	29.3	9.9	1.3	1.2	1251
2000	24.5	28.5	47.0	1245	17.7	8.4	23.9	32.9	12.1	3.0	1.9	1258
2001	30.8	26.7	42.4	1178	23.5	8.2	24.7	27.4	10.6	3.0	2.6	1185
2002	29.8	25.7	44.5	1130	20.8	8.8	23.5	29.1	12.3	2.2	3.2	1143

Table 4
Cross Market Return Correlations for Volume Portfolios

This table presents correlations between equally-weighted daily returns for TSX and TSX Venture Exchange volume portfolios. Five portfolios are formed for each market using total volume for the 12-month period.

TSX-V volume portfolio	TSX volume portfolio				
Panel A. Nov 1997-Oct 1998					
	1	2	3	4	5
1	0.235	0.232	0.268	0.267	0.203
2	0.393	0.443	0.448	0.450	0.400
3	0.404	0.512	0.495	0.502	0.443
4	0.479	0.612	0.662	0.663	0.604
5	0.520	0.666	0.743	0.783	0.728
Panel B. Nov 1998-Oct 1999					
	1	2	3	4	5
1	0.011	0.027	0.162	0.145	0.119
2	0.191	0.202	0.341	0.299	0.251
3	0.283	0.343	0.472	0.469	0.469
4	0.245	0.272	0.398	0.378	0.395
5	0.226	0.375	0.543	0.568	0.601
Panel C. Jan 2000-Dec 2000					
	1	2	3	4	5
1	0.204	0.249	0.325	0.340	0.311
2	0.305	0.427	0.473	0.501	0.414
3	0.384	0.441	0.589	0.643	0.532
4	0.457	0.616	0.697	0.766	0.711
5	0.432	0.658	0.733	0.855	0.827
Panel D. Jan 2001-Dec 2001					
	1	2	3	4	5
1	0.087	0.094	0.158	0.126	0.049
2	0.286	0.306	0.354	0.320	0.290
3	0.200	0.372	0.323	0.313	0.278
4	0.318	0.466	0.443	0.432	0.392
5	0.439	0.629	0.538	0.607	0.546
Panel E. Jan 2002-Dec 2002					
	1	2	3	4	5
1	0.025	0.078	0.078	0.058	0.047
2	0.052	0.079	0.151	0.143	0.093
3	0.089	0.212	0.260	0.256	0.275
4	0.273	0.297	0.448	0.455	0.392
5	0.286	0.329	0.500	0.608	0.533

Table 5
Cross Market Return Correlations for Price Portfolios

This table presents correlations between equally-weighted daily returns for TSX and TSX Venture Exchange price portfolios. Three portfolios are formed for each market using the median price for the 12-month period.

TSX-V price portfolio	TSX price portfolio		
Panel A. Nov 1997-Oct 1998			
	1	**2**	**3**
1	0.771	0.744	0.575
2	0.701	0.764	0.675
3	0.386	0.479	0.426
Panel B. Nov 1998-Oct 1999			
	1	**2**	**3**
1	0.611	0.606	0.399
2	0.392	0.493	0.383
3	0.234	0.267	0.275
Panel C. Jan 2000-Dec 2000			
	1	**2**	**3**
1	0.794	0.782	0.647
2	0.775	0.826	0.755
3	0.553	0.623	0.648
Panel D. Jan 2001-Dec 2001			
	1	**2**	**3**
1	0.626	0.575	0.479
2	0.524	0.567	0.492
3	0.062	0.180	0.130
Panel E. Jan 2002-Dec 2002			
	1	**2**	**3**
1	0.631	0.587	0.322
2	0.478	0.499	0.279
3	0.303	0.254	0.147

Table 6
Cross Market Volume Correlations for Volume Portfolios

This table presents correlations between mean daily volume in TSX and TSX Venture Exchange volume portfolios. Five portfolios are formed for each market using total volume for the 12-month period.

TSX-V volume quintile	TSX volume quintile				
Panel A. Nov 1997-Oct 1998					
	1	2	3	4	5
1	0.031	-0.027	-0.253	-0.250	0.222
2	-0.094	-0.012	0.024	0.134	0.139
3	-0.083	-0.042	-0.068	0.060	0.188
4	0.073	0.159	0.249	0.355	0.299
5	0.047	0.170	0.311	0.427	0.218
Panel B. Nov 1998-Oct 1999					
	1	2	3	4	5
1	0.220	0.141	0.106	0.234	0.003
2	0.307	0.382	0.305	0.269	-0.019
3	0.315	0.274	0.290	0.271	0.081
4	0.226	0.220	0.223	0.261	0.201
5	0.069	0.098	0.187	0.226	0.553
Panel C. Jan 2000-Dec 2000					
	1	2	3	4	5
1	0.443	0.426	0.493	0.402	0.281
2	0.545	0.524	0.650	0.578	0.435
3	0.410	0.410	0.538	0.514	0.434
4	0.292	0.605	0.663	0.750	0.665
5	0.164	0.629	0.659	0.847	0.706
Panel D. Jan 2001-Dec 2001					
	1	2	3	4	5
1	0.444	0.409	0.366	0.400	0.264
2	0.408	0.354	0.376	0.361	0.238
3	0.381	0.438	0.430	0.364	0.215
4	0.319	0.371	0.449	0.292	0.221
5	0.248	0.433	0.540	0.449	0.295
Panel E. Jan 2002-Dec 2002					
	1	2	3	4	5
1	0.243	0.208	0.289	0.275	0.143
2	0.275	0.290	0.395	0.314	0.104
3	0.338	0.357	0.507	0.411	0.144
4	0.358	0.338	0.568	0.567	0.323
5	0.309	0.464	0.621	0.588	0.313

Table 7
Cross Market Volume Correlations for Price Portfolios

This table presents correlations between mean daily volume in TSX and TSX Venture Exchange price portfolios. Three portfolios are formed for each market using the median price for the 12-month period.

TSX-V price portfolio	TSX price portfolio		
Panel A. Nov 1997-Oct 1998			
	1	2	3
1	0.166	0.282	0.260
2	0.028	0.134	0.169
3	-0.023	0.118	0.163
Panel B. Nov 1998-Oct 1999			
	1	2	3
1	0.542	0.364	0.299
2	0.339	0.231	0.225
3	-0.079	0.038	0.260
Panel C. Jan 2000-Dec 2000			
	1	2	3
1	0.791	0.799	0.274
2	0.672	0.758	0.317
3	0.456	0.600	0.331
Panel D. Jan 2001-Dec 2001			
	1	2	3
1	0.390	0.483	0.254
2	0.194	0.328	0.279
3	-0.049	-0.022	0.050
Panel E. Jan 2002-Dec 2002			
	1	2	3
1	0.442	0.268	0.148
2	0.292	-0.008	0.154
3	0.226	-0.133	0.066

Table 8
Changes in Prices and Market Quality around the TSX Venture Exchange Formation

For each stock on the TSX and TSX Venture Exchange with available data, the mean price, volume, relative spread and volatility are computed for three periods surrounding the formation of the TSX Venture Exchange. The three periods are one year before (November 1, 1998-October 31, 1999), and one and two years after the formation of the TSX Venture Exchange (January 1, 2000-December 31, 2000 and January 1, 2001-December 31, 2001 respectively). Next, the differences between the mean values from one and two years after and the mean value from one year before are calculated for each stock. The table presents the cross-sectional medians of these differences. For instance, the column labeled *2 years after less 1 year before* contains the medians of the percentage difference between the mean stock price and volume, and of the raw difference between relative spread and volatility calculated over the calendar year 2001 and the mean values calculated over November 1, 1998-October 31, 1999. Figures in bold are significant at the 5% level of significance. Volatility is the absolute value of the daily return, and relative spread is calculated as the bid-ask spread normalized by the stock price.

Variable	**ASE/TSX-Venture**		**VSE/TSX-Venture**		**TSX**	
	1 year after less 1 year before	**2 years after less 1 year before**	**1 year after less 1 year before**	**2 years after less 1 year before**	**1 year after less 1 year before**	**2 years after less 1 year before**
% Chg Price	0.1791	-0.1730	0.1110	-0.3730	0.0329	-0.0734
% Chg Volume	-0.3176	-0.5792	0.5119	-0.0292	0.3269	0.1878
Chg Relative spread	-0.01030	0.02370	-0.00380	0.03650	0.00003	0.00003
Chg Volatility	-0.0308	-0.0433	0.0092	0.0001	0.0039	0.0012

Table 9
Cross Market Return Correlations for ASE and VSE Volume Portfolios

This table presents correlations between equally-weighted daily returns for Alberta and Vancouver Stock Exchange volume portfolios. Five portfolios are formed for each market using total volume for the 12-month period.

VSE volume quintile	ASE volume quintile				
Panel A. Nov 1997-Oct 1998					
	1	2	3	4	5
1	-0.010	0.155	0.098	0.160	0.185
2	0.158	0.180	0.259	0.303	0.461
3	0.097	0.258	0.320	0.505	0.504
4	0.114	0.257	0.317	0.519	0.591
5	0.111	0.295	0.358	0.532	0.774
Panel B. Nov 1998-Oct 1999					
	1	2	3	4	5
1	-0.030	0.073	0.117	0.074	0.124
2	0.101	0.150	0.129	0.144	0.280
3	0.069	0.127	0.219	0.263	0.389
4	0.098	0.169	0.315	0.217	0.364
5	0.108	0.204	0.363	0.276	0.461
Panel C. Jan 2000-Dec 2000					
	1	2	3	4	5
1	0.021	0.134	0.283	0.258	0.251
2	0.060	0.301	0.349	0.414	0.438
3	0.127	0.298	0.354	0.438	0.568
4	0.236	0.340	0.554	0.606	0.742
5	0.205	0.292	0.507	0.673	0.869
Panel D. Jan 2001-Dec 2001					
	1	2	3	4	5
1	0.076	0.064	0.116	-0.021	0.095
2	0.131	0.138	0.140	0.147	0.188
3	-0.010	-0.034	0.189	0.136	0.234
4	0.028	0.043	0.120	0.134	0.400
5	0.079	0.144	0.175	0.274	0.499
Panel E. Jan 2002-Dec 2002					
	1	2	3	4	5
1	0.006	-0.028	0.078	-0.088	0.085
2	0.103	0.007	0.120	-0.002	0.206
3	0.137	0.035	0.252	0.110	0.259
4	0.037	0.008	0.180	0.210	0.316
5	0.002	0.082	0.215	0.233	0.451

Table 10
Cross Market Return Correlations for ASE and VSE Price Portfolios

This table presents correlations between equally-weighted daily returns for Alberta and Vancouver Stock Exchange price portfolios. Three portfolios are formed for each market using the median price for the 12-month period.

VSE price portfolio	ASE price portfolio		
Panel A. Nov 1997-Oct 1998			
	1	**2**	**3**
1	0.725	0.593	0.052
2	0.690	0.602	0.053
3	0.377	0.413	-0.044
Panel B. Nov 1998-Oct 1999			
	1	**2**	**3**
1	0.507	0.370	0.153
2	0.406	0.346	0.096
3	0.158	0.065	0.090
Panel C. Jan 2000-Dec 2000			
	1	**2**	**3**
1	0.833	0.775	0.578
2	0.753	0.801	0.551
3	0.283	0.353	0.242
Panel D. Jan 2001-Dec 2001			
	1	**2**	**3**
1	0.521	0.280	0.081
2	0.295	0.222	0.008
3	0.104	0.091	-0.027
Panel E. Jan 2002-Dec 2002			
	1	**2**	**3**
1	0.477	0.218	0.006
2	0.332	0.162	0.105
3	0.273	0.150	0.046

Table 11
Cross Market Volume Correlations for ASE and VSE Volume Portfolios

This table presents correlations between mean daily volume in Alberta and Vancouver Stock Exchange volume portfolios. Five portfolios are formed for each market using total volume for the 12-month period.

VSE volume quintile	ASE volume quintile				
Panel A. Nov 1997-Oct 1998					
	1	2	3	4	5
1	0.165	-0.036	0.043	-0.011	-0.068
2	-0.341	-0.459	-0.550	-0.496	-0.461
3	-0.330	-0.488	-0.542	-0.498	-0.429
4	-0.323	-0.352	-0.467	-0.427	-0.309
5	-0.181	-0.140	-0.206	-0.141	0.032
Panel B. Nov 1998-Oct 1999					
	1	2	3	4	5
1	0.248	0.197	0.160	0.108	-0.124
2	0.338	0.165	0.213	0.143	-0.127
3	0.211	0.179	0.248	0.123	-0.078
4	0.125	0.080	0.099	0.257	0.068
5	-0.033	-0.072	-0.084	0.038	0.526
Panel C. Jan 2000-Dec 2000					
	1	2	3	4	5
1	0.456	0.491	0.527	0.505	0.547
2	0.518	0.657	0.624	0.666	0.616
3	0.461	0.584	0.574	0.695	0.716
4	0.476	0.650	0.716	0.811	0.798
5	0.390	0.654	0.650	0.824	0.915
Panel D. Jan 2001-Dec 2001					
	1	2	3	4	5
1	0.041	0.182	0.205	0.124	-0.053
2	0.223	0.252	0.260	0.277	0.098
3	0.124	0.293	0.204	0.189	0.236
4	0.205	0.158	0.214	0.162	0.183
5	0.187	0.169	0.297	0.346	0.226
Panel E. Jan 2002-Dec 2002					
	1	2	3	4	5
1	0.158	0.096	0.227	0.136	0.172
2	0.302	0.275	0.333	0.219	0.225
3	0.268	0.133	0.244	0.246	0.260
4	0.207	0.211	0.292	0.259	0.364
5	0.168	0.266	0.308	0.268	0.393

Table 12
Cross Market Volume Correlations for ASE and VSE Price Portfolios

This table presents correlations between mean daily volume in Alberta and Vancouver Stock Exchange price portfolios. Three portfolios are formed for each market using the median price for the 12-month period.

VSE price portfolio	ASE price portfolio		
Panel A. Nov 1997-Oct 1998			
	1	2	3
1	-0.244	-0.002	0.048
2	0.131	0.202	0.084
3	0.062	0.096	0.075
Panel B. Nov 1998-Oct 1999			
	1	2	3
1	0.449	0.471	0.054
2	0.231	0.303	0.062
3	0.016	-0.061	-0.008
Panel C. Jan 2000-Dec 2000			
	1	2	3
1	0.921	0.719	0.582
2	0.800	0.726	0.581
3	0.498	0.459	0.357
Panel D. Jan 2001-Dec 2001			
	1	2	3
1	0.305	0.193	0.071
2	0.082	0.374	0.087
3	-0.011	0.072	0.061
Panel E. Jan 2002-Dec 2002			
	1	2	3
1	0.458	0.305	0.123
2	0.262	0.302	0.142
3	0.150	0.142	0.036

Table 13
Regression Evidence

This table presents time-series (panel A) and cross-sectional (panel B) regressions of the determinants of changes in prices and relative spreads around the formation of the TSX Venture Exchange. In each panel, coefficients in bold are significant at the 5% level of significance. Panel A of the table presents time series tests of the price and relative spread effects around the formation of the TSX Venture Exchange. The following regressions are estimated for each firm, and the table presents the median coefficients.

$$\mathrm{Re}lspr_t = \alpha + \delta Dum_{TSE-V} + \beta Volume_t + \varepsilon_t \text{ and } \frac{1}{P_t} = \alpha + \delta Dum_{TSE-V} + \beta Volume_t + \varepsilon_t,$$

where Relspr is the relative spread, P is the closing stock price, Dum = 1 after the formation of the TSX Venture Exchange and is zero otherwise, and Volume is daily trading volume. Panel B presents coefficients from the following cross-sectional regression, where the bar indicates the mean:

$$\overline{S}_{postTSX-V} - \overline{S}_{preTSX-V} = \alpha + \beta(\overline{V}_{postTSX-V} - \overline{V}_{preTSX-V}) + \varepsilon_t \text{ and}$$

$$\overline{P}_{postTSX-V} - \overline{P}_{preTSX-V} = \alpha + \beta(\overline{V}_{postTSX-V} - \overline{V}_{preTSX-V}) + \varepsilon_t,$$

where S is the relative spread, V is volume and P is the stock price.

Panel A. Time series regression coefficients

Coefficient	ASE/TSX-Venture		VSE/TSX-Venture		TSX	
	Dep var= $Relspr_t$	Dep var= $1/P_t$	Dep var= $Relspr_t$	Dep var= $1/P_t$	Dep var= $Relspr_t$	Dep var= $1/P_t$
α	0.2073	6.5414	0.2213	6.7054	0.0702	1.3930
δ	-0.0110	-1.1497	-0.0061	-0.2962	-0.0034	0.0211
$\beta(*10^7)$	-3.78	4.22	-5.13	78.78	-1.9789	2.7935

Panel B. Cross-sectional regression coefficients

Dep variable	ASE/TSX-Venture			VSE/TSX-Venture			TSX		
	α	$\beta(*10^9)$	$A\delta\varphi P^2$	α	$\beta(*10^9)$	$A\delta\varphi P^2$	α	$\beta(*10^9)$	$A\delta\varphi P^2$
Chg mean price	0.8747	2550	-0.0011	0.0064	2780	0.0117	1.2407	0.4175	-0.0007
Chg mean rel spread	-0.0114	-352.58	0.0715	-0.0048	-337.51	0.0711	-0.0049	-8.6127	0.0041

Figure 1
Cumulative Returns and Average Volume for the TSX and TSX Venture Exchange

Panel A presents the cumulative returns for the TSX index (in grey) and an equally-weighted TSX Venture Exchange index (in black). Panel B presents the cumulative returns for equally-weighted indexes for the TSX (grey) and the TSX venture exchange (black). Panel C presents average daily volume for the TSX (grey) and the TSX Venture Exchange (black). The sample period is November 1, 1997 (shown as day -500) through December 31, 2001 (day 500).

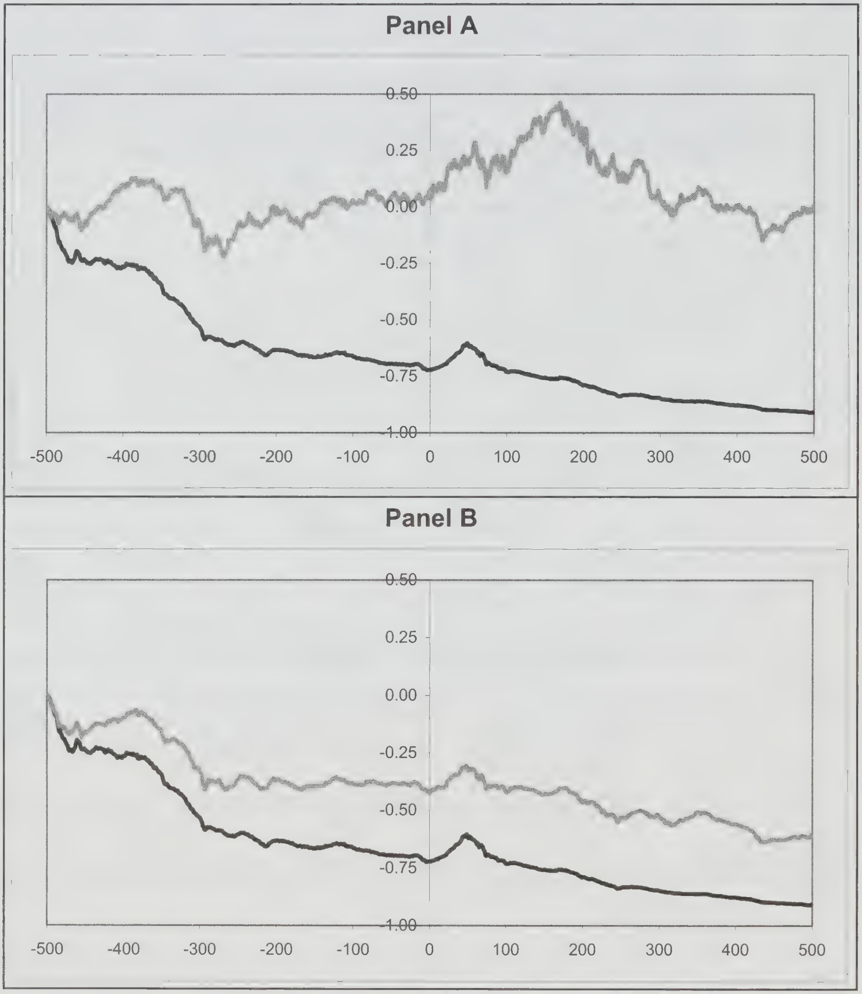


Figure 1 (cont'd)

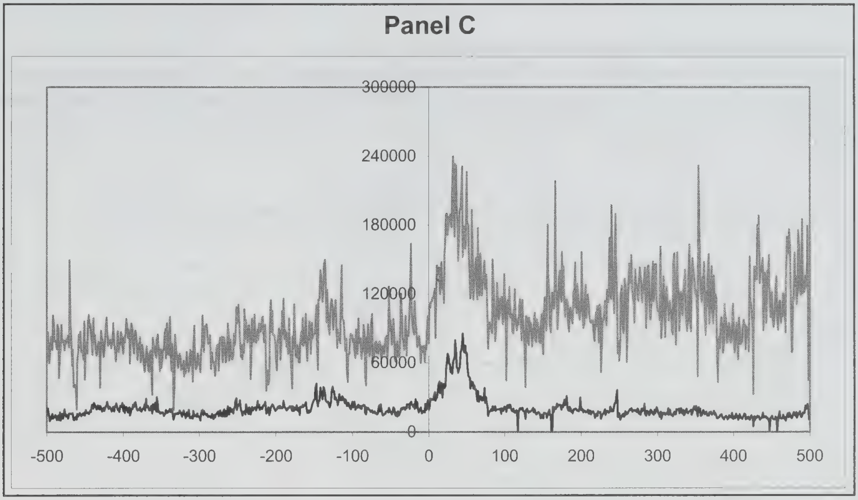


Figure 2
Cumulative Returns for TSX and TSX Venture Exchange Volume Portfolios

The figure presents the cumulative returns for five volume portfolios constructed from stocks trading on the TSX (in grey) and on the TSX Venture Exchange (in black). The cumulative returns are equally-weighted in each portfolio, and the portfolios are formed on the basis of aggregate volume in each 12-month period. The sample period is November 1, 1997 (shown as day -500) through December 31, 2001 (day 500).

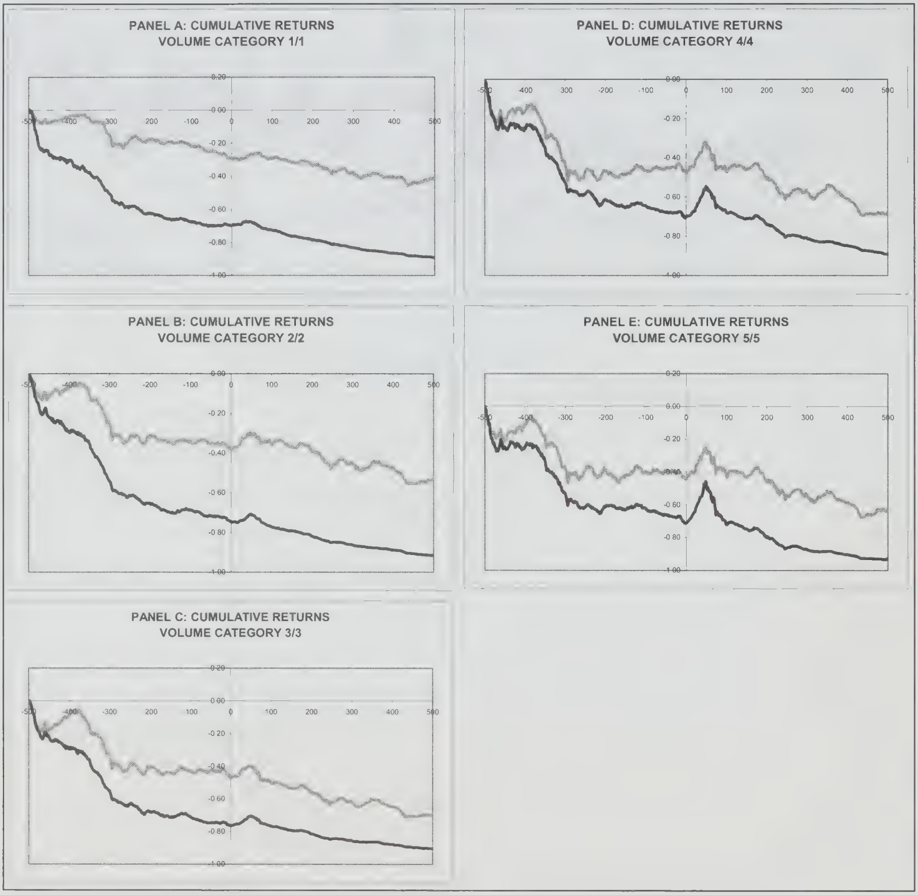


Figure 3
Cumulative Returns for TSX and TSX Venture Exchange Price Portfolios

The figure presents the cumulative returns for three price portfolios constructed from stocks trading on the TSX (in grey) and on the TSX Venture Exchange (in black). The returns are equally-weighted in each portfolio, and the portfolios are formed on the basis of the median price in each 12-month period. The sample period is November 1, 1997 (shown as day -500) through December 31, 2001 (day 500).

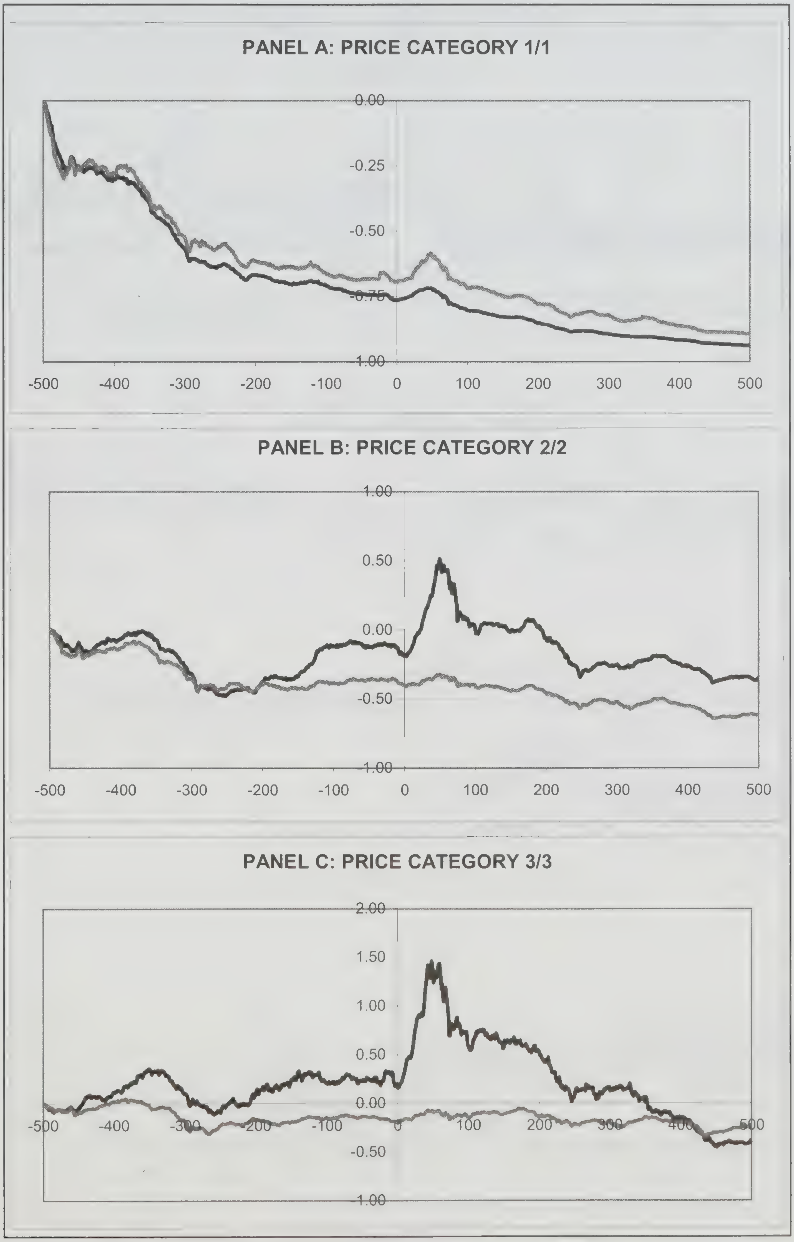


Figure 4
Average Daily Volume for TSX and TSX Venture Exchange Volume Portfolios

The figure presents the average daily volume in five volume portfolios constructed from stocks trading on the TSX (in grey) and on the TSX Venture Exchange (in black). The portfolios are formed on the basis of aggregate volume in each 12-month period. The sample period is November 1, 1997 (shown as day -500) through December 31, 2001 (day 500).

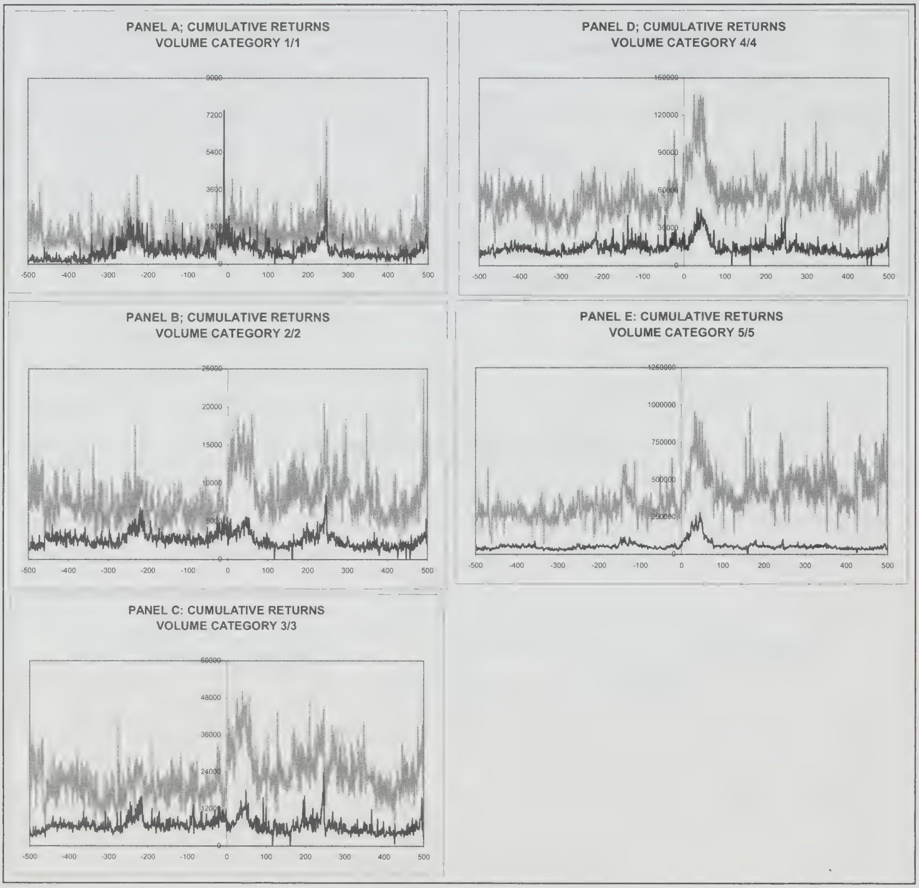
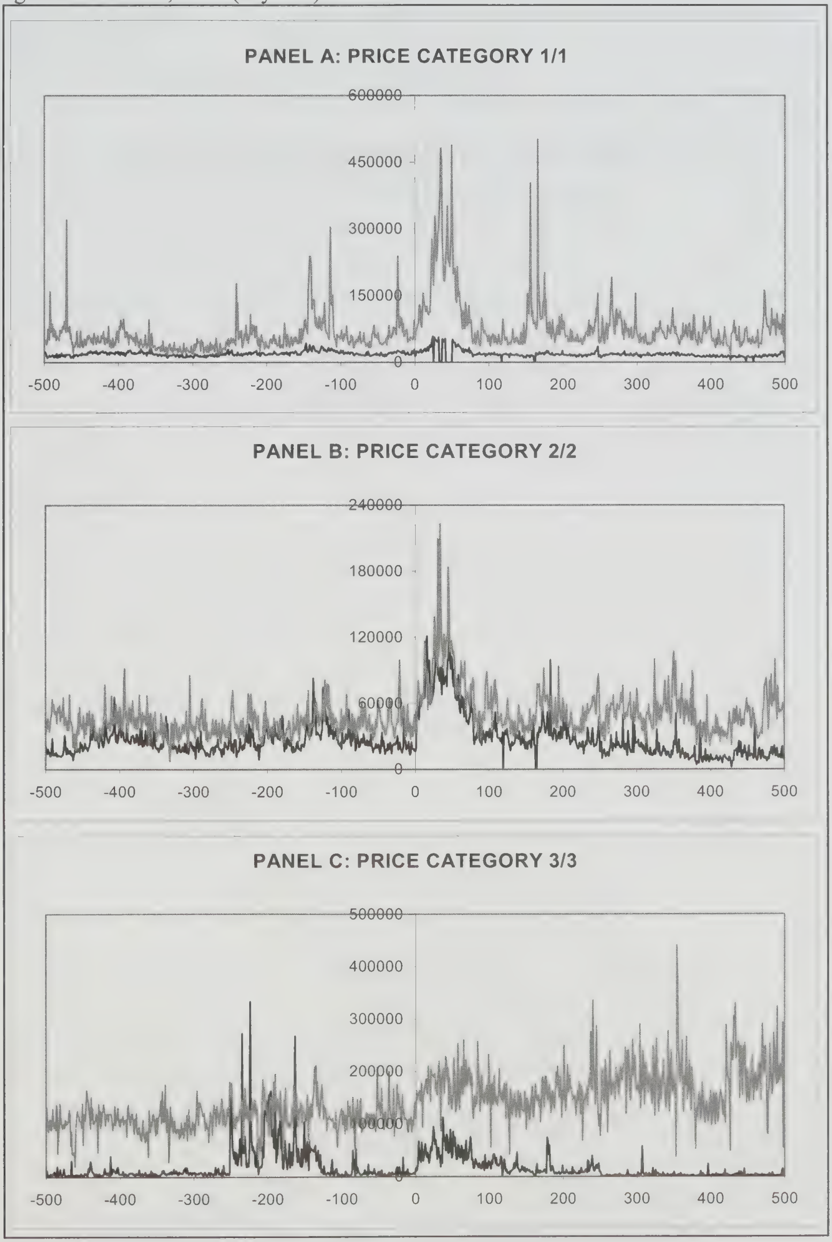


Figure 5
Average daily volume for TSX and TSX Venture Exchange price portfolios

The figure presents the average daily volume in three price portfolios constructed from stocks trading on the TSX (in grey) and on the TSX Venture Exchange (in black). The portfolios are formed on the basis of the median price in each 12-month period. The sample period is November 1, 1997 (shown as day -500) through December 31, 2001 (day 500).



The Use of Public Interest Enforcement Orders by Securities Regulators in Canada

Research Study Prepared for the
Wise Persons' Committee

Mary Condon

October 24, 2003

The Use of Public Interest Enforcement Orders by Securities Regulators in Canada

Biography

Mary Condon has been a faculty member at Osgoode Hall Law School for ten years. She is also an adjunct faculty member at the Centre of Criminology, University of Toronto. Her areas of research and teaching expertise are securities law, economic regulation, corporate law, pensions policy and socio-legal studies. She is the Director of Osgoode Hall's part-time LLM program specializing in securities law. Her book entitled *Making Disclosure: Ideas and Interests in Ontario Securities Regulation* was published by University of Toronto Press, and she is also the author of a number of journal articles and book chapters.

She is currently the holder of a Social Sciences and Humanities Research Council research grant to examine the governance of pension funds and mutual funds, and a University of Toronto Centre for Innovation Law and Policy research grant on the regulation of alternative trading systems in securities markets.

Professor Condon received her law degree from Trinity College, Dublin, and her M.A. (Criminology), LLM and S.J.D. from the University of Toronto. She received the Alan Marks Medal from the Faculty of Law, University of Toronto for her doctoral thesis. She is a member of the Bar of Ontario.

The Use of Public Interest Enforcement Orders by Securities Regulators in Canada

Executive Summary

The purpose of this study is to examine the use of discretionary enforcement powers by securities regulators in Canada, in order to assess the implications of multiple regulators for the enforcement of securities law.

Regulatory enforcement decisions for the last three (and in some provinces, five) years were reviewed along the following parameters:

- nature of infraction;
- whether the respondent was previously known to enforcement personnel;
- connection between public interest analysis and goals of securities regulation;
- use of extra-provincial regulatory precedents in decision;
- articulation of distinct provincial interest in sanctioning respondent;
- nature of sanction imposed;
- use of regulatory precedents to structure discretion; and
- use of aggravating/mitigating factors to structure outcome.

The findings of the study are that:

- There was significant variation in emphasis across the provinces in relation to infractions pursued to an enforcement hearing. Some provinces focussed, for example, on illegal distributions of securities and others on acting as a broker or advisor without registration. There was more than a trivial number of instances where respondents had been the subject of enforcement proceedings in the past. Local regulators appear to play a significant role in the setting of enforcement priorities.

- There was notable consistency across the provinces in the articulation of the public interest that was the basis for making orders. It tended to be linked more to goals of maintaining public confidence in, and integrity of, capital markets than to those of market efficiency. There was almost no expression of unique provincial objectives in making public interest orders, suggesting a high degree of consistency in the philosophical underpinnings of regulatory intervention.

- On the other hand, there was some unevenness in the application of contextual sanctioning factors to individual respondents, in order to justify specific types and quantum of penalties. Some consistency did result from reliance on two regulatory precedents – one each from B.C. and Ontario – enumerating factors relevant to the individual sanctioning decision. The bigger provinces tended to make use of the multiple sanctions at their disposal in sanctioning respondents.

These findings suggest that:

- the status quo would be enhanced by additional transparency about the setting of provincial enforcement priorities and coordination among the provinces with respect to the mitigating/aggravating factors that structure sanctioning discretion.

- Similar attempts at coordination would be beneficial in relation to a passport system, which envisages a continued role for local enforcement, based on the jurisdiction of the investor making a complaint. If this model is adopted, care should be taken not to lose the benefit of local provincial knowledge about dubious market participants.

- Under a single regulator, a decentralized enforcement model – allowing for local enforcement offices across the country – would be preferable to a more centralized enforcement model. Local input into the setting of national enforcement priorities and the development of a consistent approach to dealing with the factors influencing the quantum and type of penalty should be preserved.

The Use of Public Interest Enforcement Orders by Securities Regulators in Canada[1]

1. Purpose and Objectives of Study

This is a study of the use of discretionary administrative powers in relation to enforcement that are provided to securities regulators in all the provincial securities statutes. These powers allow the making of various kinds of orders affecting market participants such as registrants, issuers, or officers and directors of issuers. The study is a component of the research agenda established to assist the Wise Persons' Committee in its deliberations about a securities regulatory structure for Canada. The research agenda intended to support the Committee's work includes an examination of the enforcement of securities regulation. The mandate is to consider the extent to which, and how, the existence of multiple securities regulators has an impact on the enforcement of securities laws across the country.

A variety of techniques are available for the enforcement of securities law. As identified in Appendix 1, they include: criminal sanctions under the Criminal Code, penal sanctions under securities law (e.g. for insider trading, prospectus misrepresentations), and administrative sanctions (e.g. cease trading orders, denial of registration exemptions).[2]

The present study is exclusively concerned with the exercise of administrative sanctioning powers by regulators. There are a number of reasons why it is important to focus on this aspect of the enforcement of securities law:

1. These powers are particularly important to securities regulators because the regulators themselves control how and when they are used, in accordance with their governing legislation. Unlike penal sanctions or civil powers, courts are not involved at the decision stage.

2. These powers are used to sanction market participants more frequently than are penal sanctions in many provinces. They typically provide a quicker resolution of an issue and, for enforcement staff, a more manageable burden of proof. Enforcement staff may decide, if the results of an investigation do not provide adequate grounds for optimism that penal sanctions would result, to opt to seek an administrative order instead.

3. Although the orders that can be made by regulators are typically less severe than the sanctions that may be imposed by courts, significant reliance is placed on the regulatory expertise of securities commissions in making these decisions, and an amount of deference is accorded to them on judicial review.[3]

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[1] Thanks are due to Gordon Boissonneault, Raymonde Crete, Prakash Narayanan, Lynne Fonseca and Eithne Condon for their assistance.

[2] There is also the possibility in some provinces of civil orders from a court, such as a compliance order.

[3] See *Pezim v. British Columbia (Superintendent of Brokers)*, [1994] 2 S.C.R. 557; and *Committee for the Equal Treatment of Asbestos Minority Shareholders v. Ontario (Securities Commission)*, [2001] 2 S.C.R. 132.

4. Typically, securities law requires these orders to be made in the "public interest", leaving it to the regulators to interpret what the public interest requires in any specific case.

It is necessary to consider the way in which this discretion is exercised by provincial regulators so as to understand the effects of multiple securities regulators on enforcement. Thus the issue is whether there any significant differences in the way discretionary public interest powers are exercised by provincial securities regulators. Is the "public interest" protected by the British Columbia Securities Commission (BCSC) differently interpreted from that in Ontario or Quebec? Knowing whether it appears that each province is engaged in a unique enforcement enterprise, or alternatively, that there is substantial convergence in the subject matter and approach of provincial enforcement efforts, will inform the Committee's deliberations and proposals.

2. Scope of Study and Methodology

As the purpose of the study is to review the use made by regulators of the power to make administrative orders and the interpretation of the public interest contained in the statutory provisions providing the legal basis for that power, the focus was on those instances where regulators provided reasons for their decisions.[4] Decisions were initially collected in each province dating from January 1, 2000 on. While this cutoff date provided a reasonable sample of decisions in British Columbia, Alberta, Ontario and Quebec, it yielded only a small number in other provinces. Accordingly in Saskatchewan, Manitoba, New Brunswick, Nova Scotia, and PEI, decisions were retrieved from January 1998 on.[5] For each province therefore, the following number of decisions was reviewed[6]:

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4 One issue that is raised by this approach to data gathering is the handling of matters that were resolved by settlement agreement (SA). While in some provinces there were only a moderate number of matters resolved in this fashion (Manitoba: 2; Quebec: 6; New Brunswick: 6; PEI: 1), in others there were a large number of SAs during the relevant period. For example in Ontario there were 80; in B.C, 98, and in Alberta, 20. Ultimately matters resolved by SA were excluded from the sample for reasons of substance and manageability. Substantively, SAs are typically approved by regulators without a discussion of the interpretation of the public interest leading to the imposition of a sanction, or extensive discussion of the factors influencing the choice and quantum of sanction. SAs also clearly raise different issues than contested hearings do in relation to the sanction imposed. For example, SAs will not typically emphasize specific deterrence, since they require the agreement of the respondent. Similarly general deterrence will play less of a role, since agreement is often reached by the imposition of a lesser sanction in return for the cooperation of the respondent. While the use of SAs does mean that a significant number of matters are diverted out of the securities enforcement system before an opportunity arises for regulatory consideration of issues related to the public interest and the goals of enforcement, the analogy of the plea bargain in criminal law is illuminating here. Although it is widely known that the vast majority of criminal infractions never make it to the trial stage, significant aspects of criminal law and practice are based on the pronouncements of courts. Having said this, some relevant information about the nature of infractions resolved by SA in the larger provinces is described in Section 4 of this study.

5 Many of the provincial securities commissions publish their enforcement decisions on their websites. Where this was not the case, provinces and territories were contacted to provide relevant material. No decisions were provided by Newfoundland, NWT or Yukon.

6 See Appendix 2 for a complete list of the decisions considered. Where a matter involved both findings and an ultimate decision about sanctions that were reported separately, they were treated as one decision.

British Columbia	29
Alberta	11
Saskatchewan	2
Manitoba	4
Ontario	13
Quebec[7]	17
New Brunswick	3
Nova Scotia	3
PEI	1
Total	**83**

Situations where, on the basis of the investigation conducted by enforcement staff, it was determined that penal sanctions should be sought, were also excluded.

In reviewing the sample of regulatory decisions, three parameters were identified as particularly important.

The first parameter related to the *subject matter* of the hearings. Was it possible to conclude that one province consistently placed an emphasis, in the use of administrative orders, on reprimanding registrants for giving improper advice, whereas another focused more on the failure of issuers to file financial statements? Of course, the question of which securities law infractions make it to the regulatory hearing stage in any particular province is a function of a number of variables, only one of which is the policy choices that might be made by the enforcement divisions of regulatory agencies.[8] However, wide disparity in the subject matter of regulatory orders across the country might raise some issues about the relevance or otherwise of local autonomy or expertise in enforcement matters, or fragmentation of the regulatory effort. This issue will be taken up again in Section 4.

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7 The Quebec sample is an exception to the study's operating principle of gathering only infraction decisions involving reasons issued by the regulator. This is because Quebec securities legislation allows some enforcement orders to be granted without a hearing, with the opportunity provided to the respondent to have a hearing at a later date. Thus it was routine, during the period examined, for cease trade orders to be granted on the basis of a brief order from the Commission, which typically annexed the statement of allegations from the Director of Enforcement. Only three of the seventeen decisions (excluding settlements) collected from the CVMQ involved a hearing dealing with the allegations and/or sanctions to be applied. One of those, *Bombardier*, dealt with the possibility of imposing an administrative penalty, which is only a recent sanctioning option in Quebec. It is included for that reason, despite being a request to approve a settlement agreement.

8 As the study prepared by Charles Rivers Associates indicates, some of these policy choices themselves are associated with broad socio-economic factors within provinces. Other variables influencing how matters end up being pursued to a regulatory hearing might be: the nature of complaints from members of the public from year to year; media attention to specific types of securities law infractions; the types of surveillance systems put in place by market regulators; matters being resolved by SA. See Charles River Associates, "Securities Enforcement in Canada: The Effect of Multiple Regulators" (WPC Research Study, 2003).

A related issue here is the extent to which regulatory orders have been directed at *repeat offenders*. The argument has been made that a fund of "local knowledge" about unscrupulous actors in the securities industry is an important contribution of provincially-based enforcement efforts.

The second parameter was how the concept of the "public interest" was operationalized by regulators in their decisions. To what extent were the *goals of securities legislation* – usually identified as investor protection, capital market efficiency and public confidence in capital markets – used as a guide to give content to the idea of the public interest? Here it should be noted that the recent Supreme Court of Canada decision in *Asbestos*[9] reminded regulators that all of these goals, not just investor protection, should be taken into account in making regulatory enforcement orders. Thus Mr. Justice Iacobucci said that "...in considering an order in the public interest, it is an error to focus only on the fair treatment of investors. The effect of an intervention in the public interest on capital market efficiencies and public confidence in the capital markets should also be considered".[10]

Was the concept of the public interest linked in any way to *specifically provincial interests?* As it is currently organized, securities law is provincial, so that the jurisdiction of regulators is taken to extend only to enforcement in that province. However, this is not a complete answer to the question of whether the substance of the provincial interests being addressed in securities enforcement matters differs from province to province. For example, do some provinces more than others make reference to supporting local entrepreneurial or market activity in the context of enforcement? Do some provinces distinguish between the protection of retail or institutional investors in the province? An indicator of convergence or divergence here might be to discover the extent to which regulatory decisions from other provinces were used approvingly in enforcement decision-making. Widespread use of *extra-provincial regulatory precedents* could be argued to have a "convergence effect" on provincial decision-making.

The third parameter was the specific *nature of the sanctions* imposed. The relevant legal provisions typically provide a number of alternative orders that might be applicable to any given infraction (such as cease trading securities, reprimanding actors, assigning costs). Was there consistency within and across provinces in relation to the severity and type of sanction imposed for comparable infractions? The ability to draw robust conclusions here, of course, is limited by the reality that sanctioning decisions are relatively fact-specific. Is it possible to compare the *factors* that were used to make determinations as to the appropriate type and severity of sanction? Again, the use of *sanctioning precedents* as a way of structuring the discretion of regulators is a relevant consideration here.

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9 *Supra* note 3.

10 *Ibid.*

Section 3 of the study will describe the research findings, by province, under each of these parameters. Section 4 will analyze the findings, paying particular attention to conclusions that may be drawn about levels of convergence or divergence of regulatory effort in the enforcement area. Section 5 will consider the implications of the findings in the context of current reform proposals, that is, a "passport" system or a national regulator.

3. Findings

(a) *Subject Matter*

(i) British Columbia

As demonstrated by Chart 1, a variety of matters attracted enforcement orders by the BCSC over the three years considered.[11] Commissioners reserved some harsh criticism for those matters involving registrant shortcomings, describing such behaviours as particularly prejudicial to the public interest. The data indicate that the most striking recent trend in British Columbia was the frequency of hearings dealing with the distribution of securities without a prospectus. Eleven of the 29 decisions reviewed involved this infraction. Many involved complainants who were unsophisticated investors. For example, in the BCSC decision of *Dix*, the Commission noted that "the tragic element is that [the respondents] targeted an especially vulnerable group – the elderly and unsophisticated. Most were over 80 and had no knowledge of investment matters".

With respect to the possible involvement of previous offenders, 4 of the hearings reviewed related to individuals previously sanctioned by the BCSC, one involved an individual previously sanctioned by the Vancouver Stock Exchange (VSE) and one by the U.S. Securities and Exchange Commission (SEC).[12]

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[11] In each province, some decisions involved more than one infraction, and so the total number of cases reported in the charts may exceed the number of decisions.

[12] In addition, 3 hearings involved market participants involved in criminal proceedings in the same matter, and 1 involved concurrent proceedings by the VSE.

Chart 1: British Columbia

Subject matter	Number of cases
Fraud	7
Theft	2
Misrepresentation	4
Distribution of securities without prospectus / registration	11
Failure to file insider trading reports	5
Failure to fulfil directors' duties	3
Market manipulation	2
Operating a "boiler room"	2
Violating "know your client" rule	2
Failure to maintain working capital	1
Failure to establish proper procedures	1
Conduct unbecoming a registrant	1
Failure to comply with conflict of interest rules	1
Failure to comply with fair dealing rules	1

(ii) Alberta

Chart 2 shows that more types of infraction pursued to the hearing stage by enforcement staff in Alberta involved inappropriate behaviour by market intermediaries. However, by far the most common subject matter for a hearing was that of distributing securities without a prospectus or registration. This issue recurred 7 times in the 11 decisions, and was described by the Alberta Securities Commission (ASC) in the *Stuart Mutuals* decision as involving the "most serious category of violations".

In relation to "previously known" offenders, 3 of the 11 decisions involved individuals who had been the subject of previous regulatory orders by the ASC. One respondent had previously been sanctioned by the BCSC and one had a prior criminal conviction.

Chart 2: Alberta

Subject Matter	Number of cases
Misrepresentation	1
Distribution of securities without prospectus / registration	7
Failure to fulfil directors' duties	1
Trading without registration	1
Acting as adviser without registration	1
Carrying on business as exchange without approval	1
Violating "know your client" rule	1
Breach of undertaking	1

(iii) Saskatchewan

Only two public interest order hearings were identified between 1998 and 2003. One involved a mutual fund salesperson who traded in securities of a limited partnership, an activity for which he was not registered. In the course of this activity he advised clients to invest in securities which were unsuitable for them. The other also involved a mutual fund salesperson, who traded securities known as "prime bank instruments" that the Saskatchewan Securities Commission (SSC) found "closely resembles a notorious fraud". In neither case had the respondent been previously sanctioned by the Commission.

(iv) Manitoba

Three of the four instances reviewed concerned variations on the theme of breach of the "know your client" rule by registrants, with one of these also involving account churning. Thus there were recommendations of unsuitable investments and investment strategy, failures to record client information properly, improper projections of the future value of securities and unauthorized trading. The final case was one of trading securities without registration or a prospectus, along with representations as to the future value of the securities and future listing on an exchange. None of the respondents involved were previously known to the Manitoba Securities Commission (MSC).

(v) Ontario

The Ontario sample is weighted towards registrant-related issues, as demonstrated by Chart 3. This focus is consistent with a comment made in the Ontario Securities Commission's (OSC) *Arlington* decision from 2002 that "selling activities in such an environment [a securities

dealer selling to clients from a principal position] have become the focus of enforcement activity in recent years since unbridled business self-interest can conflict with the best interests of a firm's clients".

A minor but visible theme in the Ontario sample, however, is attention to corporate governance shortcomings. This is demonstrated by the specific instances of failure to fulfill corporate governance obligations, investment funds not used for proper corporate purposes, and prohibited representations about the refunding of the price of shares.

Two decisions in the sample involved respondents who had been the subject of regulatory action by the OSC in the past. Another involved a respondent who had given a previous undertaking to the SSC and a third involved an individual who had made previous settlement agreements with the CDNX and the TSE. Finally one respondent had been convicted in criminal proceedings in New York.

Chart 3: Ontario

Subject Matter	Number of cases
Insider trading	1
Distribution of securities without prospectus / registration	1
Failure to file insider trading reports	1
Failure to make full, true and plain disclosure of material facts	1
Failure to disclose material changes	1
Failure to fulfil corporate governance obligations	1
Improper use of investment funds	1
Making prohibited representations re refunding share price	1
Trading without registration	4
Acting as adviser without registration	2
Breach of obligation to act in client's best interests	2
Failure to deal fairly and honestly with clients	1
Conduct unbecoming a registrant	1
Excessive markups by securities dealer	1
Failure to disclose financial interests	1
Breach of settlement agreement	1

(vi) Quebec

Chart 4 shows that the infractions dealt with in the Quebec sample are widely dispersed over a number of issues, but again are clearly weighted towards a variety of registration-related issues, and specifically those of acting as a broker without registration, and acting as a financial advisor without registration.[13]

Two of the cases involved respondents who had previously been the subject of enforcement action: one whose registration had been cancelled, and the other who had been ordered to cease trading and engaging in financial advising.

Chart 4: Quebec

Subject Matter	Number of cases
Distribution of securities without prospectus / registration	2
Issuing securities in contravention of ME rules	1
Signing false prospectus	1
Abuse of exemptions	1
Inadequate disclosure in financial statements	1
Failure to abide by issuers policy on information disclosure	1
Failure to file insider trading reports	2
Trading without registration	6
Acting as adviser without registration	5
Acting as portfolio manager without registration	1
Failure of underwriter to act with diligence, competence and probity	1
Failure to consider clients' interests	1
Appropriation of client funds	1
Failure to maintain sufficient risk adjusted capital	1
Making prohibited undertakings re listing of securities	2

13 There was some overlap in these two categories.

(vii) New Brunswick[14]

All three cases involved an assessment of whether it is in the public interest to suspend or cancel a registration. The impugned behaviour of two of the registrants involved, respectively, trading securities without a certificate (prospectus), and assisting a non-registrant to process securities trades. The third registrant proceeded against had engaged in a wide variety of inappropriate behaviour.[15]

In the latter case, enforcement staff had been concerned about the individual's suitability for registration in 1991, because of his failure to disclose his second bankruptcy within six years. At that time, registration had been reinstated subject to specific conditions of registration and a requirement for close supervision by the employer.

(viii) Nova Scotia

All of the decisions involved hearings to approve settlement agreements, all involved the same type of matter and the reasons were crafted in almost identical terms in all three cases. The three respondents involved were investment funds which offered securities pursuant to the *Community Economic-Development Corporation Regulations*. Each contravened the provisions of these regulations by failing to provide the required information circulars to their security holders and by failing to obtain majority approval for various investments.

(ix) PEI[16]

In determining whether a registrant (*Morse*) would be eligible for re-registration, the Director of Corporations uncovered examples of breach of fiduciary duties to clients (by way of taking loans from clients) as well as trading securities to clients without a prospectus.

(b) *Concept of the Public Interest*

(i) British Columbia

Here the most common interpretation of the public interest, as it relates to the overall goals of securities law, was that of the need to maintain the "integrity of the capital markets". Almost all of the decisions reviewed used that formulation as a way of describing the purpose of public interest orders or the need to impose a sanction in the specific case, and in some instances the suggestion was made that this was significant above and beyond harm to specific investors.

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14 The public interest orders that can be made by securities regulators in New Brunswick extend only to registration issues. A registration may be suspended or cancelled in the public interest.

15 This behaviour included: taking loans from clients; failure to disclose material facts about investments to clients; failure to disclose status as bankrupt to securities regulators; failure to ensure client's interests paramount; intent to deceive client; failure to report securities violations; violation of special conditions of registration; and committing fraudulent acts.

16 The power of securities regulators to make public interest orders in PEI is likewise more circumscribed than in other provinces. The regulator has the discretion to remove exemptions in the public interest, and may also grant or suspend a registration. An application for registration may be refused "where on reasonable grounds the Director considers the order to be necessary".

Only four of the decisions linked the public interest to all three of the typical legislative goals (investor protection, capital market efficiency, and public confidence). While two decisions considered the importance of striking a balance between investor protection and facilitating capital raising, no decision singled out capital market efficiency as a predominant way of characterizing the public interest. Some of the decisions noted that the purpose of making public interest orders was to be preventive and prospective, in other words, to avoid future harm rather than to remedy past infractions.

In terms of whether the making of public interest orders was linked to specifically provincial concerns, the evidence here is limited. Only two decisions addressed this in any way. In *Cartaway,* the BCSC noted that although the issuer was a reporting issuer in Alberta and its securities were traded only on the Alberta Stock Exchange, "there was a national market for Cartaway shares" and residents of British Columbia were trading the shares in the secondary market. Furthermore the registrants whose conduct was impugned in the decision were employed in Vancouver. Thus "it is within this context that we will exercise our public interest jurisdiction". On the other hand, in *Fairtide* the Commission noted that "unregistered trading and advising are serious problems in our capital markets and pose a significant threat to investors, whether or not they reside in our province".

None of the BCSC decisions referred to precedents derived from other provincial regulatory agencies, and only one made reference to an SEC decision.[17]

(ii) Alberta

Several of the recent Alberta enforcement decisions did not place their analysis of the public interest in the context of the overall goals of securities law. However, earlier decisions tended to focus on the need to make public interest orders for investor protection purposes and to maintain the integrity of the capital markets. Again, there was no attention paid to the goal of achieving efficiencies in the markets, though one decision quoted approvingly the reminder from Mr Justice Iacobucci in *Asbestos* that the public interest encompassed all three goals of securities regulation. Thus, typical comments were those of the ASC in the *Stuart Mutuals* decision, to the effect that "we cannot protect the public interest and the integrity of the capital markets if we tolerate deliberate violations of securities law..." or, in *Lamoureux* that "The Commission and other securities regulatory authorities in Canada have also expressed their view that, when making orders under s.198 or 199... to protect the public, we consider a broad range of factors...."

There was even more uniformity in the Alberta decisions about the requirement that public interest orders are "preventive in nature and prospective in orientation", that is, oriented towards the prevention of future harm rather than the punishment of infractions.[18]

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[17] In the *Noram Capital Management* case, reference was made to an OSC decision in the same matter.

[18] A frequently-quoted formulation of this is to be found in the ASC's 1991 decision of *Matheson*, that "protecting the public interest encompasses a broad range of considerations. These include protecting the public from the future conduct of a particular respondent who has engaged in inappropriate conduct in the past; alerting others that inappropriate conduct will be halted by the Board and informing others that offending persons will not be allowed to participate in the industry; prescribing public confidence in the capital markets; as well as adjudicating on other factors which may be specific to individual cases".

The *World Stock Exchange* decision noted that "it is impossible to precisely define the public interest in the context of innovative or evolving exchange activity. While the public interest remains relatively constant, and is quite clearly reflected in the regulatory requirements imposed upon the actual activities of recognized exchanges, exchange activities are almost infinitely variable". Thus for the ASC "the most important distinguishing characteristic of the WSE [World Stock Exchange] is its general lack of regulation, manifested in business practices that are contrary to the public interest". Two decisions emphasized the special role of registrants in the protection of the public interest.

One striking feature of the Alberta sample is the resort to regulatory precedent in outlining the general principles to be used to guide discretionary sanctioning. These precedents encompassed decisions of the ASC itself, such as *Matheson*, occasionally the BCSC's *Eron* and *Orr* decisions (see below), but in five decisions included precedents from the OSC. The two OSC decisions most frequently cited were *Mithras Management* and *Belteco*.

In terms of our inquiry as to whether the public interest being protected was composed of distinctly provincial concerns, only two of the decisions are noteworthy. *World Stock Exchange* concerned an "Internet stock exchange" which solicited a number of Albertans and Alberta companies to raise money on the WSE. In response to the claim that WSE was not carrying on business in Alberta, the ASC concluded that it had "legitimate interest in applying Alberta law to the WSE merely because its activities have unlawful consequences here". Furthermore "the WSE's potential victims include anyone with Internet access so, in this situation, comity encourages us to apply Alberta law because the WSE's links to Alberta allow us to act and because we would want other jurisdictions to take a similar approach".

The *Morrison Williams* decision concerned an investment portfolio manager based in Toronto who provided advice to a single client in Alberta, while unregistered under the Alberta statute. The ASC noted that "local registration has always been a fundamental tenet of securities regulation". This "does not imply that we have less faith in other regulators regarding registration and prospectus requirements.... Rather, it reflects one of the objectives of the Act, namely protection of local public investors". The ASC must "look to the effect of the activity in Alberta and the consequences for Alberta investors".

(iii) Saskatchewan

Relatively little attention was paid in either of these decisions to expanding on the meaning of the public interest in applying enforcement orders. However, it was noted in the application of sanctions in the *Bergen* case that "as the conduct involved a significant number of people and attendant publicity it constituted a significant setback to confidence in the Saskatchewan capital markets". Bergen's conduct was contrary to the public interest because he "had not demonstrated the knowledge and attitudes necessary to fulfil his duties as a registrant". No extra-provincial precedents were cited to clarify the requirements of the public interest, nor was any uniquely provincial definition of the public interest identified.

(iv) Manitoba

Little attention was paid to expanding on the meaning of the public interest in the course of determining sanctions in these cases. *Max Systems*, which involved trading securities without a prospectus, enumerated a number of "public interest factors" which removed the matter from "being simply a technical breach". These included factors such as the sale of securities to the estate of a seriously injured minor, undertakings as to the future price of the securities, and false and misleading statements made to investors and to staff of the MSC. The Commission in the same case noted that its actions "must appear to punish fault and protect any future investors", echoing the future-oriented nature of the reasoning in other enforcement decisions. No extra-provincial precedents were cited to clarify the requirements of the public interest, nor was any uniquely provincial definition of the public interest identified.

(v) Ontario

Several of the decisions in the Ontario sample linked the idea of the public interest to the achievement of the goals of securities law. Thus in *Lydia Diamond*, the OSC noted that it was "required to exercise [its] jurisdiction under ss. 127 and 127.1 of the Act by making orders in the public interest, taking into account the purpose of the Act in s.1.1 and the principles set out in s. 2.1". Looking across the span of the decisions however, it is possible to see that more attention tended to be paid to the idea of protecting the integrity of the capital markets and confidence in those markets than the other purposes. For example in *Banks,* the OSC said that "if we do not restrain Banks properly, confidence in our markets would be weakened".

The *Donnini* case did allude to the goal of capital market efficiency, in the specific context of the payment of costs as an aspect of public interest sanctioning. Thus, the commission considered that "cost recovery is fair to other participants in the capital markets. In *Asbestos*, Justice Iacobucci emphasized the importance of the Commission considering the efficiency of the capital markets when exercising its public interest discretion". Eight of the Ontario decisions declared that public interest orders were required to be preventative and prospective rather than oriented towards punishing respondents.

One unique feature of the Ontario sample is the linking of the OSC's public interest jurisdiction to maintaining appropriate standards of corporate governance. For example in *Banks*, it was decided that "...where a respondent has egregiously failed to adhere to existing standards or principles of corporate governance, and a respondent's past conduct has convinced us that without one or more orders, future harm is likely to occur, it is appropriate for us to make an order in the public interest". A similar concern is evident in *Meridian Resources*.

In *Lydia Diamond*, the OSC described its order as "designed to strike a balance between the interests of the respondents and the interests of the public". In *Prydz,* it was concluded that breach of a settlement agreement was "itself an action contrary to the public interest".

There is very little evidence in the Ontario sample of the use of extra-provincial precedent to interpret the concept of the public interest. Only the *Valentine* matter used a securities

regulation decision from the B.C. Court of Appeal to ground the OSC's analysis of the basis for extending a temporary cease trading and suspension of registration order. The OSC's own *Mithras Management* decision was cited several times, as was *Asbestos*.

(vi) Quebec

It has been noted already that only three of the Quebec sample involved a hearing by the CVMQ. The emphasis in two decisions was on the goal of investor protection. In *Shedleur*, involving an underwriter who participated in an underwriting where only a fraction of the funds raised was retained for the objectives listed in the prospectus, and who signed off on a prospectus containing false information, the Commission noted that one of the objectives of the law was to frame the behaviour of professionals in the marketplace in order to protect investors. A comment from *Pezim* concerning the protective role of securities regulators was also quoted approvingly in the decision.

In *Laliberté,* which specifically addressed the power of the CVMQ to render an enforcement decision without a hearing, it was noted that decisions were made in the public interest, and more generally to avoid serious prejudice to the functioning of the markets, to protect investors against underhand, abusive and fraudulent practices and to promote the disclosure of adequate information to the market.

In *Bombardier* the Commission said that in defining the public interest, it generally referred to its mission, defined in s. 276 of the Quebec statute as the promotion of efficiency, the protection of investors, the regulation of information disclosure and the definition of a framework for the activities of professionals. The same case also noted that despite its obligation to achieve these goals, it also had the obligation to treat fairly those subject to its authority. All three decisions asserted that the objective was not to punish individuals. In *Exploration Malartic-Sud*, the Director of Enforcement's application to the Commission for sanctions against the officers and directors of the company noted that it was in the public interest that those who authorized the issuing of company securities in contravention of MSE rules should not be allowed to trade those securities until the company conformed with the rules.

In *Shedleur*, the Commission referred to the Supreme Court of Canada decisions of *Pezim, Asbestos* and *Global Securities*, as well as the OSC precedent of *Ames*, a decision also involving the responsibilities of underwriters. However there was no articulation of a uniquely Quebecois definition of the public interest in these decisions.

(vii) New Brunswick

Given the specific nature of the public interest power in New Brunswick, it is not surprising that the meaning of the public interest was articulated in the context of registrant responsibilities. Thus, in *Arsenault,* it was noted that "(T)he privilege of registration under the *Securities Act* imposes on individuals important standards in order to protect the investing public and ensure that overall public interest is maintained". Here it is also suggested that the ethical standards required of registrants have become more onerous because of "the increasing number

of investors and the importance the investing process has become (sic) for most citizens". *Bond* stated that "(B)reach of industry codes of ethics ... are equated by regulators as being contrary to the public interest".

More generally, *Bond* referred to the goals of securities regulation articulated in the Ontario statute as a possible guide to the public interest. The Administrator continued that "...the public interest ... must encompass ... all investors resident in New Brunswick and the regulatory system itself which the legislature has put in place to protect them. The integrity of this system can be jeopardized even if there is no evidence of immediate, substantial or individual harm". Other than this reference to investors resident in New Brunswick, no specific provincial definition of the public interest was articulated.

(viii) Nova Scotia

Most of the Commissions reasons were taken up with discussion of the appropriateness or otherwise of the sanctions sought by enforcement staff. No reference was made in the decisions to the goals of securities law, though the decision was clearly grounded in concern for "harm to security holders" and specifically the exposure of their investment to "greater risks" by the lack of disclosure and opportunity to debate the merits of specific investments. No regulatory precedents were cited.

In so far as these decisions turned on the failure to abide by the provisions of a specific program which offered an "abbreviated public offering process designed to provide the Respondent with a cost effective means of accessing a community based capital market", there is a specific provincial interest articulated here. This is an interest in the existence of this program and its appropriate use by investment entities, in order to further local investment goals, while minimizing risks to investors.

(ix) PEI

It was noted in *Morse* that "ethical conduct is vital to ensuring the integrity of markets" and that "the industry consistently puts forth requirements of high ethical conduct for the protection of the public and the industry... Business conduct which is detrimental and uncaring of the public interest will not be tolerated". No precedents were cited, and no specifically provincial public interest was articulated.

(c) *Sanctions Imposed*

(i) British Columbia

One consistent feature of sanctioning decisions in B.C. was that multiple sanctions were almost always employed. Thus an individual or issuer typically attracted a cease trading order, a denial of exemptions order, an administrative penalty, and sometimes a costs order. A prohibition on acting as a director or officer of an issuer was another very common sanction employed, and where registrants were involved, a prohibition on investor relations activities was often included.

We have noted that the largest category of infraction in this sample was that of distributing securities without a prospectus. In terms of the time periods for which the multiplicity of sanctions noted above were imposed, on two occasions exemptions were denied for five years and a low administrative penalty was imposed ($5,000). However in the majority of instances the time periods involved ranged from 10 years up to a permanent cease trading or denial of exemptions order, and administrative penalties ranged from $25,000 to $100,000. In the case of the most serious types of infractions, such as fraud or market manipulation, time periods began at eight years and administrative penalties at $10,000. One fraud case involved an administrative penalty of $200,000. At the lower end of the seriousness spectrum, for example infractions of insider reporting rules, there was again some fluctuation in the time periods and penalties involved. Here, the range was between six months and five years and penalties were between $3,000 and $10,000.

Some attempt to structure the exercise of sanctioning discretion was evident, by means of the employment of specific BCSC precedents which enumerated a list of relevant factors to assist in decision-making. Two decisions were consistently cited: *Orr*, an insider reporting case, and *Eron Mortgage*, a February 2000 decision which involved distributing securities without a prospectus and misrepresentation. As *Orr* itself cited the factors listed in *Eron,* it is fair to say that the latter is the current benchmark in B.C. for enumeration of the factors to be considered in making various types of sanctioning decisions. These factors are:

- the seriousness of respondent's conduct;
- the harm suffered by investors as a result of the respondent's conduct;
- the damage done to the integrity of the capital markets in British Columbia by the respondent's conduct;
- the extent to which the respondent was enriched;
- factors that might mitigate the respondent's conduct;
- the respondent's past conduct;
- the risk to investor and the capital markets posed by the respondent's continued participation in the capital markets of British Columbia;
- the respondent's fitness to be a registrant or to bear the responsibilities associated with being a director, officer or adviser to issuers;
- the need to demonstrate the consequences of inappropriate conduct to those who enjoy the benefits of access to the capital markets;
- the need to deter those who participate in the capital markets from engaging in inappropriate conduct; and
- orders made by the Commission in similar circumstances in the past.

It should be noted that there is currently some legal controversy in relation to the "general deterrence" factors enumerated as relevant in *Eron.* A majority of the B.C. Court of Appeal has ruled in *Cartaway*[19] that the SCC decision in *Asbestos* should be interpreted as holding that securities regulators' public interest function allows them only to consider specific deterrence in fixing the amount of administrative penalties.

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[19] (2002) BCCA 461.

The *Orr* decision in November 2001 added to this list another set of factors specifically relevant to the situation of failure to file insider trading reports. This list was gleaned from earlier BCSC decisions and settlements involving the reporting of insider trades. This list consists of the following factors:

- the volume of shares in the unreported trades compared to total trading in the stock;
- the number of unreported trades;
- the duration of the non-compliance;
- whether the respondent disclosed and rectified the deficiencies voluntarily;
- the respondent's subsequent conduct;
- the respondent's previous disciplinary history;
- the respondent's cooperation with the Commission staff investigation; and
- the presence of any aggravating factors.

Many of the decisions reviewed can be seen to be applying the various factors identified in *Eron*, such as the risk to investors if the respondent continues to be present in the markets, the respondent's lack of prior regulatory problems, or the extent to which the respondent received payment for his/her efforts. A few additional mitigating factors also appear in some decisions, such as the respondent's acknowledgment of his responsibilities as a registrant, whether or not the respondent cooperated with commission staff in the investigation, or a last minute restitution payment. Finally the issue of whether or not to take into account the consequences of the sanction to the respondent seems to cause some controversy. A couple of decisions show a willingness to reduce the administrative penalty based on ability to pay, while another notes that it would not "serve the public interest to permanently deprive [the respondent] of career opportunities". Yet another decision notes that the consequences to the respondent of the sanction to be imposed is not a relevant factor.

(ii) Alberta

In relation to the most commonly found infraction – distributing securities without a prospectus – there was significant variation in the sanctions imposed in different cases, ranging from a case where multiple sanctions (denial of exemptions, cease trading and a prohibition on acting as a director or officer) were imposed for one year to one where the multiple sanctions were imposed for 20 years along with an administrative penalty of $25,000. The difference appears to reflect the presence of "aggravating factors" in the latter situation, such as the characterization of the illegal distribution by the ASC as a "deliberate and deceptive victimization of investors" as well as an "intentional breach of [an] undertaking" to the ASC. Similarly, as might be expected, multiple respondents in the same matter are treated differently according to the degree of culpability found by regulators.

We have seen that both ASC and other regulatory precedents are used in these decisions to guide the factors relevant to the sanctioning decision. The ASC's *Press* decision was twice cited for the proposition that there is a spectrum of circumstances relevant to a sanction for an illegal distribution, depending on whether there was an intention to comply with the Act or not. In another case the *Eron* decision from B.C. was mined for its list of factors to be considered in sanctioning. We have seen that one OSC decision – *Belteco* – was popular for the same reason.

The relevant passage from *Belteco* is as follows:

> "we have been referred to decisions of this Commission which indicate that in determining both the nature of the sanctions to be imposed as well as the duration of such sanctions, we should consider the seriousness of the allegations proved; the respondent's experience in the marketplace; the level of a respondent's activity in the marketplace; whether or not there has been a recognition of the seriousness of the improprieties; and whether or not the sanctions imposed may serve to deter not only those involved in the case being considered, but any like-minded people from engaging in similar abuses of the capital markets".

With respect to the deterrence factor, it should be noted that the needs of general deterrence were frequently cited as a relevant factor by the ASC.

Additional aggravating factors identified by the ASC included: deliberate violation of the Act, lack of understanding of the appropriate regulatory duties; incompetence and exaggeration of profits to be made in an investment opportunity; and violation of regulatory undertakings. Meanwhile mitigating factors referred to included: cooperating with enforcement staff and reliance on legal advice. The consequences of the sanction to the respondent were <u>not</u> to be considered, nor the respondent' conduct at the hearing. In crafting appropriate sanctions, the ASC was twice careful to avoid imposing undue hardship on customers or "innocent employees" of an issuer and was prepared to limit a prohibition on acting as a director or officer of an issuer to holding these positions in a junior issuer only, on the basis that the latter provided limited oversight to compensate for the respondent' lack of judgment.

(iii) Saskatchewan

Both of these cases involved mutual fund salesmen trading in high risk securities for which they were not registered. In *Singh,* the SSC considered that "any association by a registrant in any way with the provision of information of such a dubious proposal is, if not criminal, grossly negligent and cannot be condoned" However, multiple sanctions (denial of exemptions, cease trade order, no advising order, resign as director/officer, and future prohibitions on holding positions as director/officer or being employed by an issuer/registrant) were applied to Singh for three years, and to Bergen (denial of exemptions, cease trade order, no advising order, resign as director/officer, and future prohibition on holding position as director/officer, administrative penalty of $50,000 and costs of $5,000) for ten years.

The difference here seems to revolve around the amount of money lost and the personal circumstances of the respondents. In *Bergen* several million dollars were lost by investors, whereas in *Singh* it does not appear that any investor had yet actually invested any money. The SSC also noted that the personal circumstances of Mr. Singh required some consideration.[20] A lifetime of removal from the industry would be "extremely harsh".

[20] These were the facts that he was young, relatively new to the business of securities sales, and had four children.

In both cases, some attention was paid to the goal of general deterrence. In *Bergen*, the Commission considered the need to "demonstrate the consequences of inappropriate conduct to those who enjoy the benefits of access to the capital markets" In *Singh*, it was noted that "too short a period [of exclusion from the markets] will do nothing to convince any registrant of the extreme concern" about similar schemes.

In *Bergen* mitigating factors included: his cooperation in the investigation; efforts made to assist customers in mitigating losses; and the fact that he was not as responsible as other actors to whom maximum penalties were applied.

Finally, in *Bergen*, there was some resort to precedent in determining the specific sanctions to be applied. The factors enumerated in the BCSC decision of *Eron Mortgage* were cited, as was another BCSC regulatory decision (*Connor Financial)*, and finally, an earlier settlement with a principal actor in the same incident was used for comparative purposes as a guide to the sanction to be imposed.

(iv) Manitoba

Two of the three registrant-related cases involved the sanction of a reprimand, in one case together with the requirement to pass an examination and to pay costs of $4,000. In the third case, a permanent denial of exemptions was assessed, along with costs of $20,000. In *Max Systems*, the various individuals and entities received the denial of exemptions sanction for different periods of time, along with denial of registration and costs for the individuals, and an opportunity for the issuer itself to have access to exemptions on the approval of the MSC.

The *Finley* decision used the earlier registrant-related enforcement decision of *Tetrault* to guide its sanctioning decision, noting that although there were many similarities in the two cases, there was none in relation to the degree of fault involved. In *Max Systems*, the settlement agreement reached with another actor in the case was used to guide the sanctions imposed for the individual respondents.

In terms of factors relevant to individual sanctioning decisions, we have seen that the seriousness of the violation was an important consideration in determining outcomes. We have also noted the "public interest factors" identified in *Max Systems* as significant in reaching an appropriate sanction; including the sale of highly speculative shares to the estate of someone unable to look after their own interests and false and misleading statements made to MSC staff. The decision noted that the fact that securities were traded on the basis of deficient offering documents "knowingly and in disregard of Commission decisions only exacerbates the offense". The impact on the respondent was considered, in the sense that the sanction imposed on the issuer itself in *Max Systems* was calibrated in order to allow it to continue to raise financing in a controlled fashion and thereby prevent harm to "innocent shareholders".

(v) Ontario

Across similar infractions, e.g. trading without registration or advising without registration, variation can be observed in the specific orders made. This likely reflects the presence or absence of "aggravating factors". Multiple sanctions (such as, cease trade orders, denial of exemptions, reprimand) were a feature of these decisions. On the basis of one case it is hard to draw a conclusion as to whether infractions considered to be more serious, such as insider trading, attract higher sanctions, though this is the case in the *Donnini* example. As might be expected, the costs imposed on respondents in Ontario matters tend to be significantly higher than in the other provinces.

There is limited evidence of the use of regulatory precedents to guide specific sanctioning decisions. *Belteco* and the factors enumerated there makes an appearance in *YBM, Lydia Diamond* and *Donnini*. In *Arlington*, the OSC used settlements made in previous "high mark-up" cases as a guide in assessing appropriate sanctions.

Aside from the guiding factors listed in *Belteco*, a few others can be extracted from these decisions. Issues such as: whether the violations were isolated or recurring, whether there was reliance on legal advice, whether there was a breach of a previous undertaking to a regulator, lack of any "real intention" to be bound by a settlement agreement, all contributed to specific sanctioning outcomes. Several decisions noted the importance of considering issues of specific and general deterrence.

In *Donnini*, the OSC cited approvingly the passage from its decision in *M.C.J.C.* to the effect that the impact on the respondent was important in determining the appropriateness of public interest sanctions. In the same vein, the OSC tended to pay close attention to the connection between the impugned conduct and the actual sanction imposed. Thus a cease trading order and a prohibition on acting as a director or officer was not imposed in *Costello*, because the impugned conduct did not pertain to trading. In *Donnini* the commission noted that the respondent should not receive more severe sanctions than otherwise appropriate because he had not agreed to settle.

Finally the *Etherington* case identified some relevant mitigating factors, including the facts that the respondent was not aware that his financial planning activities might be in breach of registration provisions, that his website had no customers, he had attempted to acquire the relevant training, and there was no evidence of financial loss.

(vi) Quebec

The most common sanction imposed in the Quebec sample was the cease trade order, though it was sometimes combined with a ban on acting as a financial advisor, or a suspension of registration. There was one example of a requirement to issue a press release to explain a default in meeting disclosure requirements, and one freeze order. The cease trading orders imposed tended not to be time limited, though in at least one case *(Laliberte)*, an order was lifted on demonstrating that the appropriate material had been filed with the Commission. In *Shedleur*, the underwriter involved was suspended for seven years.

In *Shedleur*, the gravity of the respondent's actions and his knowledge of the securities markets were cited as reasons for a severe sanction. In *Laliberte*, the insider reporting issue, relevant factors cited by the Director of Enforcement were that (i) his transactions represented an important volume of stock exchange transactions, and (ii) a sanction was "essential" to promote the well-being of the market and the protection of investors. In later addressing the question of lifting the cease trade order in the *Laliberte* matter, the CVMQ noted that his behaviour subsequent to the initial imposition of the order was relevant to its decision.

In *Bombardier*, the CVMQ remarked that had this matter involved action taken against the company by enforcement staff, the penalties assessed would have taken into account the harm to investors. Finally, no regulatory precedents were referred to in making these orders.

(vii) New Brunswick

In *Arsenault*, the respondent was suspended immediately, with the stipulation that no further application would be considered for 6 months, along with proof of successful completion of an IFIC course. In *Logan*, a reprimand was placed on the registrant's file. In *Bond*, the case involving the most serious infractions, the Administrator was convinced that the individual was unfit for registration. However, because he was not currently registered, it was resolved to place the decision in the respondent's file and on the public record, with the expectation that it would be given serious consideration should he reapply.

The decision on sanctions in the *Bond* case was guided by the OSC's *Mithras Management's* discussion of the need to restrain future conduct that is likely to be prejudicial to the public interest, along with the *Smith* decision of the NBCA concerning the need for fairness when assessing penalties. The decision also referred approvingly to the OSC's *Dornford* decision, in particular its recognition of the importance of general deterrence. Beyond this, earlier regulatory decisions, either of the Administrator himself or "other securities regulators" such as the IDA or the MSC, were considered less useful as a source of guidance. This was because penalties had become more severe over the decade.

There was no doubt in these cases that deterrence was an appropriate goal of the sanctioning decision. *Bond* pointed out that the Act's "public interest mandate necessitates both specific and general deterrence be consequences of administrative processes involving registrants", and that the latter was important to "maintain an effective regulatory system for the protection of the investing public". However in *Logan* the need to achieve deterrence "must always be balanced" with the "clear and cogent evidence of serious wrongdoing" required before a registrant is to be deprived of an opportunity to earn a living.

Aggravating factors enumerated here included: active involvement in the impugned distribution of securities, declarations of bankruptcy, "convictions, violations of other regulatory statutes, civil proceedings and other employment or business relationships which might lead to potential conflicts of interest" (*Bond*), as well as conduct that was "pervasive, deliberate and contrary to all standards of practice". Meanwhile, mitigating factors were the admission of the allegations, the lack of evidence of "intentional fraudulent conduct", cooperation in the investigation, and "being humbled by the experience".

(viii) Nova Scotia

In each of these cases an administrative penalty of $2,500 was imposed, which was explicitly characterized as at the lower end of the range. Costs of $500 were also assessed.[21] No sanctioning precedents were cited. The violations involved were described as "substantive" as opposed to procedural. It was concluded that there was no need to consider issues of specific deterrence as the respondents had implemented the appropriate procedures; however it was determined that it is "in the public interest to impose an administrative penalty in an amount that will serve as a general deterrent to violations of the *Community Economic-Development Corporation Regulations* and other securities laws of Nova Scotia".

Mitigating factors cited included the absence of malice or an "intent of personal profit" on the part of the respondents, as well as the fact that they were "responsive and cooperative" throughout the investigation. Finally, an invalid factor to consider was that the regulatory requirements infringed upon had been "understated" by the administrators of the program.

(ix) PEI

The sanction imposed in *Morse* was that no application for registration would be entertained for six months, Morse was required to rewrite and successfully complete an examination before being registered, and he was required to pay $2,000 towards the cost of the investigation.

The Director noted that in exercising his registration discretion, "the totality of the candidate's application must be considered". Relevant factors were that two of the clients to whom Morse had breached his fiduciary duty were "unsophisticated investors", and that he had not been truthful with the investigators dealing with this matter.

4. Analysis of Findings

(a) *Subject Matter*

The most striking area of variation in this comparative sample is that of the nature of the infractions that are the subject of public interest orders. All provinces are concerned to some extent about specific shortcomings in registrant behaviour, whether the issues are breach of the "know your client rule", failure to deal with clients fairly and honestly, or in the Atlantic provinces, taking loans from clients. But B.C. and Alberta both pay a significant amount of attention to sanctioning the distribution of securities without a prospectus, especially where this involves sales to retail investors. This issue has not rated much attention at all in Ontario or

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[21] The maximum allowable penalty is $100,000. The regulations to the Nova Scotia *Securities Act* also prescribe costs of $50 per hour for the time of the Director, or any Deputy Director or any lawyer, investigator or accountant employed by the Commission.

Quebec in the last few years, with these provinces having more of a focus on acting as a market participant (broker/advisor) without registration[22]. Some provinces pay attention to whether insiders report their trading adequately, some do not.

What are the implications of this difference in emphasis for analysing the impact of multiple regulators on enforcement? Some of the variation, of course, has to do with differences in the governing legal framework in relation to enforcement. We have seen that public interest orders in New Brunswick are only available in relation to registrants. In Quebec, cease trade orders can be made quickly, without a hearing; other sanctions cannot be applied in this way.

It might also be the case that local investors complain about different things in different provinces, leading provincial enforcement staff to respond accordingly. It is important to remember, however, that provincial enforcement divisions typically receive many more complaints than subsequently become the subject of enforcement orders. For a variety of reasons, some, if not all provinces clearly engage in some form of strategic planning or priority setting with respect to enforcement. This priority setting may affect not only the response to complaints from investors. The cases reviewed suggest that enforcement personnel are also willing to take proactive action, for example, targeting securities dealers, approaching websites offering investment services to verify registration status, or acting on information received from another division of the agency. It appears, for example, that while B.C. made significantly more public interest orders than other provinces over the last few years, Ontario is more willing to address novel enforcement issues, such as the adequacy of corporate governance among issuers[23] or

22 This picture is rendered somewhat more complex if settlement agreements are taken into account. We have seen that in larger provinces like BC and Ontario, more matters are resolved by SA than by contested hearing. It should be noted however that a focus on numbers of settlements as opposed to hearings may somewhat overstate the ratio of SAs to hearings. This is because some SAs in these provinces represent separate agreements with different respondents in the same matter, whereas a hearing is more likely to deal globally with a number of different respondents. A survey of concluded SAs in Ontario and BC during the relevant time period shows that 27 out of 80 SAs in Ontario involved the distribution of securities without a prospectus. This was the most common subject matter for an SA in Ontario. In BC, this infraction occurred 30 times out of 98 SAs, and was also the most common subject matter there. However, in Ontario, an infraction resolved by SA that occurred almost as frequently (on 24 occasions) was that of trading without registration. In BC this infraction emerged in 18 SAs. In BC, failure to file insider trading reports was resolved by SA on 13 occasions, whereas in Ontario this occurred only 3 times. Meanwhile, the next most common infractions to be noted in Ontario, failure to assess the suitability of an investment/sale of unsuitable investments (15) and inadequate supervision of traders (10) can be observed in BC SAs 5 (with an additional 5 involving failure to make "know your client" inquiries) and 6 times respectively.

Taken as a whole, this additional information concerning SAs does not undermine, and arguably supports, the points made above about variation in enforcement emphasis across the provinces. While the SA information from Ontario does show more attention to the issue of distributing securities without a prospectus than is visible from the hearings data, there still appears globally to be more of a focus on this problem in the BC context. It should be noted for example that 7 of the 27 SAs dealing with distributions without a prospectus in Ontario involved sales of the same securities by a number of different individuals. Further, the SA information supports the conclusion that Ontario is particularly concerned about trading without registration as well as shortcomings in registrant (broker/advisor/mutual fund sales personnel and their firms) behaviour.

23 At least where issuer corporate governance practices have securities regulation implications, for example practices in relation to disclosure of information.

registrants, or excessive markups by securities dealers. Thus, the difference in subject matter emphasis across the country is, to a significant extent, a product of provincial enforcement policy-making.

A complete answer to the question of *why* the local generation of enforcement policy produces different emphases in enforcement outcomes is a broader question than can be adequately dealt with in the context of this study. However a few comments may be made. It has been noted that the Charles Rivers Associates study for the Wise Persons' Committee emphasizes broad socio-economic factors in provinces as relevant to the question of differences in provincial securities enforcement trends. It has also been suggested to this researcher in interviews with senior enforcement personnel in several provinces that enforcement policy-setting is reactive to the perceived reality that the nature of the local market is different, for example, as between B.C. and Ontario. Thus, for example, the B.C. securities market is considered to be dominated by promoters and junior resources companies attempting to raise financing in the most cost-effective manner. Similarly, the local financial services sector is considered to be different from that in Ontario, with respect to the size and scope of the registrants operating in it.

Another possible explanation relates to how specific provincial securities commissions are funded. Thus, for example, an agency such as the OSC, which is funded in large part by revenue generated from securities industry registrants might be more likely to concentrate its internal enforcement resources on matters of most concern to those registered with it, in a context where external enforcement resources, in the form of penal sanctions, are also available. This hypothesis suggests that the question of how regulators are funded to undertake their activities is an aspect to be considered in any proposals for change.

More generally, in terms of the mandate of the Wise Persons' Committee, the question then becomes whether it is optimal for local regulators to set enforcement policy. On the one hand, the argument, again, is that local regulators are closer to the local market, and in the best position to develop a sense of how and when dubious market participants might be operating in that market. Presumably they develop that sense in part from reacting to investor complaints and in part from engaging in other forms of surveillance or information gathering. On the other hand, it is the case that very few of the types of infraction pursued by provincial regulators are *by definition* local, although some are pursued with greater intensity in some provinces more than others. The fact that different inappropriate behaviours are targeted for attention in different provinces may result in a lack of overall coordination with respect to the focus of enforcement efforts, which may have an impact on the overall use of enforcement resources. It might also suggest that the chances of being sanctioned for specific infractions, for example distributing securities without a prospectus, are lesser in some provinces than others.

Apart from the issue of establishing enforcement priorities, what do the findings of this study suggest about the argument that enforcement needs to be local because local enforcement personnel know who the "bad actors" are? It is apparent that, certainly in the bigger provinces, there were more than a few occasions where the respondents who were the subject of public interest hearings had previously come to the attention of that provincial agency. The proportions

are slightly more pronounced, in provinces like B.C. and Ontario, if enforcement action by the local stock exchange is also included. While this may be something of a self-fulfilling prophecy, in the sense that enforcement staff might be quicker to act on a situation involving someone they are aware has been previously investigated, it does suggest that it is relevant to have a base of local expertise in relation to market participants and their activities.

(b) ***Concept of the Public Interest***

What is the effect of multiple regulators on the meaning of the "public interest" that is the basis for making discretionary enforcement orders? Here there is more consistency across the country. There was considerable agreement that the predominant purpose of making these orders was to protect the integrity of the provincial capital market, and to engage in a future-oriented analysis of the respondent's likely behaviour, with sanctions being applied if necessary to achieve the goal of maintaining public confidence in the market's ongoing integrity.

This uniform sense of the purpose of the enterprise no doubt has a lot to do with the convergence effect of Supreme Court decisions like *Asbestos*, though consensus could be observed even before that decision was handed down. It is noteworthy too that even since the *Asbestos* decision's stricture to consider market efficiency issues in making enforcement orders, this aspect has been largely ignored to date. On the other hand, the convergence effect of citing extra-provincial regulatory precedents to ground a public interest analysis is quite limited, as only the Alberta sample features this practice to any significant degree.

It is also quite clear that in most provinces there is no robust articulation of a provincial public interest that can be distinguished from any existing in other provinces. While the issue is raised in provinces like B.C. and Alberta, it is addressed there only in the context of the jurisdiction of regulators to act. Since regulators' jurisdiction currently extends only to the well-being of investors in their province, a connection to those investors typically needs to be established for an order to be made.

In the sample reviewed, only Nova Scotia and Ontario could be said to have articulated a provincial public interest that is substantively unique: the former with reference to maintaining the integrity of a local investment program and the latter identifying elevated standards of corporate governance with the public interest in a couple of decisions.

(c) ***Sanctions Imposed***

In attempting to generalize about the specific sanctions that are applied across the provinces, it must be acknowledged that decisions here are quite fact-specific. However it can be seen that the bigger provinces tended to make use of all the sanctions at their disposal in structuring specific outcomes, so that respondents were subject to multiple sanctions.[24] The exception to this is Quebec, which is likely a function of the fact that the application of some sanctions requires a hearing and others do not.

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24 Appendix 1 indicates the penalties which may be applied in each province, according to the relevant governing legislation.

In B.C., Alberta, Saskatchewan, Ontario and New Brunswick, there were attempts to structure the discretion to apply sanctions by resorting to regulatory precedents which enumerated factors relevant to decision-making. In terms of the precedents used, the provinces were ranged around two poles consisting of the *Eron* decision from B.C., and the *Belteco* decision from Ontario. Although there is quite an amount of overlap in the factors enumerated in both precedents (such as the seriousness of the conduct, the respondent's past conduct, and the need for deterrence), the *Eron* list includes a broader set of issues to be taken into account.

All the provincial regulators, whether or not they subscribed to *Eron* or *Belteco*, also attempted to justify the use of their discretion to sanction by articulating mitigating or aggravating circumstances that helped produce specific outcomes. Chart 5 below attempts to capture a sense of the extent to which there was convergence around the use of these sanctioning factors to guide outcomes. The chart shows a large array of factors used in different provinces, with quite a number being subscribed to by only one or two provinces. There was most agreement about the relevance of (i) the respondent's level of cooperation with enforcement/investigation staff, and (ii) the degree of culpability for the harm caused, as among a number of respondents in the same matter.

In at least one instance – the issue of whether to consider the consequences to the respondent in crafting the sanction – there is outright disagreement among provinces. At least one decision each in B.C. and Alberta take the view that the consequences to the respondent should not be considered in choosing the sanction, while decisions in B.C. (again), Saskatchewan, Manitoba, Ontario, and New Brunswick are prepared to give some weight to this issue in determining the outcome.

Also, there is an amount of enthusiasm across the provinces for paying attention to general deterrence in deciding on a regulatory sanction. However recent decisions in B.C. have noted that the province's Court of Appeal takes a different view of the ability of securities regulators to do this, so that enforcement practices here may be influenced in the future by a Supreme Court pronouncement on the matter.

Thus, while employment of regulatory precedents in sanctioning practices in some provinces suggest attempts at harmonization, the use of a wide range of additional parameters for decision-making across the country indicates that much diversity remains. In terms of the preoccupations of the present study, the issue again is whether the ability to craft an appropriate sanction is inherently a local issue. It has been argued that it is appropriate for different provinces to have different penalties for infractions. The CSA's "Blueprint for Uniform Securities Laws for Canada"[25] posits that "(L)ocal differences in amounts of penalties are appropriate and reflect the

[25] (2003) 26 OSCB 943.

fact that jurisdictions with larger markets and issuers may need a higher penalty in order for their enforcement powers to be meaningful".[26] However it is somewhat more difficult to make this argument in relation to the *rationale* used for an enforcement outcome. It is unclear why, for example, reliance on legal advice should be a mitigating factor in Alberta and Ontario, but not in B.C.. None of the decisions reviewed articulate a rational basis for why particular mitigating or aggravating factors are popular in some provinces but not others. Without such a rational basis for variation, the effect of local autonomy in relation to the factors influencing sanctioning outcomes seems to be to produce unevenness and fragmentation of enforcement efforts.

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[26] However the CSA does argue that the types of enforcement orders available to regulators should be harmonized. *Ibid* at 979.

Chart 5: Sanctioning Factors

Aggravating / Mitigating Circumstances	BC	AB	SK	MB	ON	QC	NB	NS	PEI
Deliberate / unintentional violation of Act		✓			✓		✓	✓	
Violations isolated / recurring					✓		✓		
Breach of undertaking		✓			✓				
Knowing violation of Commission decision				✓	✓				
Co-operation / lack of co-operation with staff	✓	✓	✓	✓			✓	✓	✓
Acknowledgement of registrant responsibility	✓	✓							
Reliance on legal advice		✓			✓				
Incompetence		✓							
Degree of culpability		✓	✓	✓		✓	✓		
Harm to investors						✓			
Making good on client losses	✓		✓						
Amount of money lost			✓		✓				
Involvement of unsophisticated investors				✓					✓
Knowledge of securities markets						✓			
Proportion of overall transactions involved (insider trading)						✓			
Declaration of bankruptcy							✓		
Previous legal proceedings							✓		
Admission of allegations / humbled by experience							✓		

5. Implications of the Findings for Reform Proposals

This section considers the implications of the research findings about the use of public interest orders for a variety of possible reform proposals that might be made by the Wise Persons' Committee, such as (i) an enhanced version of the status quo; (ii) a passport system, as proposed in the provincial ministers' June 2003 discussion paper[27]; and (iii) a single regulator.

(a) *Status Quo*

If the emphasis on local autonomy in relation to enforcement is to be maintained, the findings above suggest that it would be beneficial to have more transparency about, and stakeholder input into, the development of provincial regulatory priorities in this area. This might help to reduce somewhat the risk of uneven enforcement coverage across the provinces in relation to infractions of securities law.

With respect to the factors that influence sanctioning outcomes, greater coordination among the provinces would likewise be helpful in order to increase consistency, with specific attention paid to resolving emerging disagreements about the relevance of factors like the consequences of the sanction for the respondent. Some effort should be devoted to developing a template of appropriate factors for provincial regulators to consider in choosing the quantum and type of penalty.

(b) *Passport System*

As it is currently described, it does not appear that the implementation of a passport system would change much about the way enforcement is currently organized. The passport document assumes that "local regulators are in the best position to assess investor complaints".[28] Accordingly it proposes that relations between investors and market participants would be governed by regulators in the investors' jurisdiction, and the local laws of the investor's jurisdiction would apply. Such a system would maintain a high degree of local autonomy in relation to how investor complaints are ultimately dealt with in accordance with provincial enforcement priorities.

In so far as it is reactive to investor complaints, it would assist only to a limited extent in the overall rationalization of enforcement policy, priority setting or the consistent use of discretionary factors in sanction decisions. Consideration should be given to whether it might actually inhibit enforcement personnel from taking proactive action that is not triggered by investor complaints. The focus on where the investor is as opposed to where the market participant is means there might in some circumstances be less ability to capitalize on local knowledge about market participants who have come to the attention of regulators in the past. As at present, it would also require coordination among regulatory authorities where market participants target investors in more than one province.

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27 *Securities Regulation in Canada: An Inter-provincial Securities Framework* (2003).

28 *Ibid* at 11.

(c) *Single Regulator*

There are various ways in which the move to a single regulator model could be achieved. Scenarios involving both centralized or decentralized enforcement could be envisaged. In other words, the model could involve a single enforcement division which would send teams of investigators around the country, or alternatively that the single regulator would maintain local enforcement offices in the larger provinces.

The findings of the present study suggest that the latter option might be more effective at capitalizing on the local information gathering and surveillance connected to enforcement efforts. It would be obviously important to preserve local input into the setting of enforcement priorities in a national context, as well as into the rationalizing of the discretionary factors influencing sanction outcomes.

One key issue would be whether or not there would be a single decision-maker applying a uniform set of administrative enforcement powers. Fewer decision-makers might enhance efforts at a consistent approach to the use of these discretionary factors. The present uniformity around the definition of the public interest suggests no particular obstacles to developing an articulation of a national public interest to be protected by securities enforcement efforts.

Appendix 1
Penalties

Penal Sanctions under Criminal Code, 1985	
Nature of Offence	**Maximum Years of Imprisonment**
Fraud	10
Fraudulent manipulation of stock exchange	5
Spreading false news	2
False pretences or statements	10
Gaming	5
Conspiracy	10
Short sales	5
Breach of trust by public officials	5

Maximum Punishment by Province

Regulatory Offence	BC	AB	SK	MB	ON	QC	NB	NS	PEI	NF	YK	NWT
Misleading / untrue statements / omissions		$1M and/or 5 years jail	$1M and/or 2 years jail	$1M and/or 2 years jail	$5M and/or 5 years jail	$20K (ind) $50K (co) and/or 5 years jail		$1M and/or 2 years jail		$1M and/or 2 years jail	$2K and/or 1 year jail (ind) $25K (co)	$2K and/or 1 year jail (ind) $25K (co)
Failure to file record	$1M and/or 3 years jail	As above				As above						
Failure to obey decision / undertaking	As above	As above	$1M and/or 2 years jail	$1M and/or 2 years jail		As above		$1M and/or 2 years jail		$1M and/or 2 years jail	$2K and/or 1 year jail (ind) $25K (co)	$2K and/or 1 year jail (ind) $25K (co)
Contravention of securities law	As above (if listed section)	As above (if listed section)	As above	As above	$5M and/or 5 years jail	As above (if listed section)	$2K or 6 mo jail (ind) $5K (co) (if listed as offence)	As above	$1M and/or 2 years jail	As above	As above	As above
Unfair or fraudulent practices						As above			As above			
Hindering investigation						As above						
Permitting offences by directors / officers	$1M and/or 3 years jail	$1M and/or 5 years jail	$1M and/or 2 years jail	$1M and/or 2 years jail	$5M and/or 5 years jail	$20K (ind) $50K (co) and/or 5 years jail		$1M and/or 2 years jail	$1M and/or 2 years jail	$1M and/or 2 years jail	$2K and/or 1 year jail	$2K and/or 1 year jail
Insider trading	$1M or triple profit made / loss avoided	$1M or triple profit made	$1M or triple profit made	$1M or triple profit made	$5M or triple profit made / loss avoided and/or 5 years jail	$1M or 4x profit made / loss avoided and/or 5 years jail		$1M or triple profit made		$1M or triple profit made		

Notes:

- ind = individuals / co = companies / mo = months
- Fines are for both individuals and companies unless otherwise noted.

Orders Available by Province

Nature of Administrative Order	BC	AB	SK	MB	ON	QC	NB	NS	PEI	NF	YK	NWT
Comply / cease contravening	✓		✓					✓				
Cease trading	✓	✓	✓	✓	✓	✓		✓		✓	✓	✓
Suspension / imposition of conditions on registration			✓		✓		✓		✓	✓		
Denial of exemptions	✓	✓	✓	✓	✓	✓		✓		✓		
Resignation of officers / directors	✓	✓	✓		✓			✓		✓		
Prohibition from becoming officer / director	✓	✓	✓			✓		✓		✓		
Prohibited / required to disseminate / amend information	✓	✓	✓		✓			✓		✓		
Reprimand	✓		✓		✓	✓				✓		
Freezing disposition of funds, securities, assets						✓						
Notice of fraud to public							✓		✓			
Cease advising			✓									
Disgorge profits made					✓							
Review practices					✓					✓		
Costs	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓
Penalty	$250K (ind) / $500K (co)	$100K (ind) / $500K (co)	$100 K	$1M (ind) / $5M (co)	$1M	$1M		$100 K				

Notes:

- ind = individuals / co = companies / mo = months
- Fines are for both individuals and companies unless otherwise noted.

Appendix 2
Securities Commission Decisions

British Columbia (2003-2000)

1. Robert Pierre Lamblin et al
2. American Gold Mining Corporation
3. Robert Douglas McLean
4. Carl Glenn Anderson and Douglas Victor Montaldi
5. Fairtide Capital Corp et al
6. Danny Francis Bilinski
7. Specialized Surgical Services Inc. et al
8. Jesse J. Hogan
9. Malcolm Stevenson
10. Andrew Rutherford Prowse
11. Adamo Guerrini
12. Frederick George Orr
13. Tri-West Investment Club et al
14. Randall Kane Garrod
15. Gordon Dix Jr. et al
16. Robert A. Diiannii
17. Cartaway Resources Corporation et al
18. Gill Financial Corporation and Nirbhia Singh Gill
19. George Stephen Slightham et al
20. Paul Schiller an Betty Schiller
21. Jack Weatherell
22. Noram Capital Management Inc.
23. Andrew Willman
24. Jean B Claude Hauchercorne
25. TAC International Ltd. And Craig Southwood
26. John Terrance Pyper
27. Dean Ward Bishoprick
28. Excel Asset Management Inc. et al
29. Eron Mortgage Corporation et al

Alberta (2003-2000)

1. David John Del Bianco et al
2. Gordon Hunte
3. Christopher Peter Agagnier
4. Marc Lamoureux
5. Cartaway Resources Corporation et al
6. National Gaming Corporation et al
7. Group Athletic Services Corp. et al
8. Valiant Place Inc. et al
9. World Stock Exchange et al
10. Morrison Williams Investment Management Ltd.
11. W.H. Stuart Mutuals Ltd. et al

Saskatchewan (2003-1998)

1. Darcy Lee Bergen
2. Canadian Residents' Umbrella Plan and Sanjeeva Ranjan Singh

Manitoba (2003-1998)

1. David Wayne Finley
2. Max Systems Inc. et al
3. Roland Emile Terault
4. Michael Sidiropolous

Ontario (2003-2000)

1. YBM Magnex International Inc. et al
2. Stephen Duthie
3. Meridian Resources Inc. and Steven Baran
4. Brian K. Costello
5. Jack Banks
6. Lydia Diamond Exploration of Canada Ltd. et al
7. Terry G. Dodsley
8. Ronald Etherington and Create-A-Fund Incorporated
9. Mark Edward Valentine
10. Arlington Securities Inc. and Samuel Arthur Brian Milne
11. Piergiorgio Donnini
12. Richard Thomas Slipetz
13. Mikael Prydz

Quebec (2003-2000)

1. Stevens Demers and Marie-Claude Coulombe
2. Coop Services et Recherches Santé 3E Millénaire (S3M) et Denis Roy
3. Enviromondial Inc.
4. Fonds de Croissance Emerging 3rd Millennium Inc. et al
5. Daniel Bélanger et al
6. Exploration Malartic-Sud Inc. et al
7. Rampart Securities Inc.
8. Elias Zilkha et al
9. Jean Dussault (Interdiction de Prononcer)
10. Guy Shedleur
11. Première État Finance Inc. et al
12. Benoît Laliberté
13. Jitec Inc. and Benoît Laliberté
14. Roger Gagnon and 2645-8083 Québec Inc.
15. Corporation Cinar
16. Jacques Quirion et al
17. Bombardier Inc.

New Brunswick (2003-1998)

1. Emile Arsenault
2. Gordon Arthur Bond
3. Bruce R.H. Logan

Nova Scotia (2003-1998)

1. Baie Chedebucto Bay Investment Fund Ltd.
2. Evangeline Wind Field Inc.
3. Northeastern Community Investment Incorporated

Prince Edward Island (2003-1998)

1. David Emery Morse

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Securities Enforcement in Canada: The Effect of Multiple Regulators

Research Study Prepared for the
Wise Persons' Committee

Charles River Associates

October 21, 2003

Securities Enforcement in Canada:
The Effect of Multiple Regulators

Biographies

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Charles River Associates (CRA) is a leading provider of economic, financial and business strategy consulting, with offices throughout the world.

Margaret Sanderson

Margaret Sanderson is Vice President and head of CRA's Toronto office. Ms. Sanderson has experience analyzing the economic effects of a wide range of business conduct and government regulatory policy across a diverse set of industries. In the finance sector, Ms. Sanderson has led CRA projects that involved: estimating the costs that are attributable to the multiplicity of Canada's securities regulators; assessing whether Canadian rules and regulations contribute to higher retail trading costs in Canada; and measuring the potential effects on Canadian equities markets of a non-synchronous change in settlement period between Canada and the U.S. Prior to joining CRA, Ms. Sanderson was responsible for managing the Competition Bureau's resources dedicated to providing economic expertise on competition cases, regulatory interventions and policy. In this capacity she was responsible for the *Merger Enforcement Guidelines as Applied to a Bank Merger*. Ms. Sanderson holds an M.A. in Economics from the University of Toronto.

Mark Neumann

Mark Neumann is an Associate Principal within CRA's Toronto office. Dr. Neumann has expertise in financial economics, industrial organization and econometrics. Since joining CRA, Dr. Neumann has been the principal economist on all of CRA's Canadian finance projects, including work undertaken for the Canadian Capital Markets Association, Investment Dealers Association, Ontario Securities Commission and private securities clients. In addition to his finance-related expertise, Dr. Neumann has considerable experience in economic modeling, econometric and simulation analysis, and competition analysis. As well, he has analyzed the initial stock price performance of firms undertaking initial public offerings of equity, the costs associated with raising debt and equity finance, and the effect of investments abroad on firm performance. While previously working as an economist at the Department of Finance, he undertook research of Canadian demographics and the housing market. Dr. Neumann holds a Ph.D. in Economics from the University of British Columbia.

Securities Enforcement in Canada:
The Effect of Multiple Regulators

Executive Summary

Enforcement of securities laws is extremely important. Simply having a law on the books is insufficient to ensuring effectively functioning capital markets. Academic research shows that a country experiences a substantial decrease in the cost of equity the first time that there is evidence that existing insider trading laws are enforced.[1] Such a decrease in the cost of equity is not found when insider trading laws are initially enacted. Thus, an effective enforcement regime will enhance market value.

Securities enforcement is a highly complex regulatory activity, a testament to the extent of and the complexity of securities laws, rules and regulations. While for many individuals, enforcement brings to mind high-profile cases such as those involving YBM Magnex International Inc, Bre-X Minerals Ltd. or Livent Inc., regulators must routinely deal with many smaller cases. Inquiries and investigations may be launched into a wide range of activity, from trading without registration or engaging in abusive sales practices to fraudulent financial statements or insider trading. Violation of securities laws may affect a few individuals within a small community or it may affect thousands of investors dispersed across continents.

Quite apart from the general complexity of securities enforcement, Canada's system of regulation operates through 13 provincial and territorial securities regulatory authorities and three self-regulatory organizations (SROs). Of the SROs, two bodies are particularly active in enforcement matters, the Investment Dealers Association (IDA) and Market Regulation Services Inc. (RS).

Each securities regulator and SRO enforces its respective act, rules or regulations by allocating resources and adopting the enforcement practices that it finds best suited for fulfilling its particular mandate. While all regulators wish to ensure investor protection and foster strong capital markets, this may be accomplished through varying emphasis on enforcement relative to other regulatory activities. Budgets need to be allocated between policy-making, compliance and enforcement. Within enforcement, functions (and hence budgets) are further divided between surveillance, case investigation, and litigation. Finally, regulators determine what resources to dedicate to specific cases or types of cases.

The resources dedicated by a regulator to any particular investigation in turn affect the time and cost that private parties incur to cooperate with (or defend themselves against) the regulator. Should multiple regulators investigate the same or similar conduct, or require variations in the resolution of any particular enquiry, private parties' costs increase.

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[1] Utpal Bhattacharya and Hazem Daouk, "The World Price of Insider Trading" (2002) 57 Journal of Finance 75.

In light of the complexity of securities regulation, the multiplicity of regulators in Canada can impact several dimensions of enforcement activity. In this study, we undertake the following:

- We compare and contrast enforcement activity levels and budget resources across the commissions, the IDA and RS, as well as with certain U.S. securities regulators;

- We test the extent to which differences in socio-economic factors explain the observed differences between commissions in respect of enforcement, using certain U.S. state securities regulators as a comparison group;

- We examine the extent to which the current system leads to regulatory overlap and jurisdictional limitations, such that there is sub-optimal enforcement – either too much or too little – compared to a single regulator; and

- We estimate the lost economies of scale in enforcement budgets due to the multiplicity of regulators compared to having a single regulator with regional branch offices.

To address the above issues, we collected data from each of the commissions as well as the IDA and RS. Data was also solicited from the U.S. Securities and Exchange Commission (SEC) and various U.S. state commissions. We interviewed enforcement officials in several commissions to gather additional non-quantitative information. As well, we interviewed securities litigators for their views of the current regulatory environment, and the impact it has on their clients.

Our efforts to gather data for this study exemplify one of the issues generated by multiple regulators and the frustrations facing many market participants. While we requested the same information from each commission, the data we obtained varies considerably across commissions and SROs in its detail and completeness.

From the information we assembled and our subsequent analysis, we have drawn the following summary conclusions:

1. There are substantial differences between commissions in respect of their enforcement activities:

    - In respect of inputs, enforcement staff and budgets differ across commissions, whether compared on a per capita basis or relative to gross domestic product (GDP). Enforcement budgets are generally larger for bigger provinces. There is no discernable relationship between jurisdiction size and the percentage of commissions' total budget allocated to enforcement.

- Compared to the U.S. jurisdictions, Canadian commissions devote a smaller percentage of their total budget to enforcement. As well, enforcement budgets for the largest Canadian commissions – Alberta, British Columbia, Ontario and Quebec – are lower, on average, than for U.S. securities regulators of comparable size whether the comparison is made on a per capita basis or relative to GDP.

- For any given number of staff devoted to enforcement, the proportion of staff allocated to case assessment, investigation and surveillance, and litigation is similar across the commissions for which we have this more detailed data (Alberta and Ontario).

- When comparing enforcement outputs – either investigations per capita, relative to GDP or per $100,000 enforcement budget – there is a strong positive relationship between the number of investigations and population for the smaller commissions, but not for the larger commissions. This likely results from the use of screening systems by the larger commissions to prioritize enforcement cases.

- For those commissions for which we have detailed data on the type of investigations launched (Ontario and Manitoba) the top ranked types of investigations (ranked by percent of all investigations) differ across commissions. While investigations of sale of unregistered securities represent the largest percentage of investigations for Manitoba, it is ranked seven of ten categories for Ontario. The largest number of investigations for Ontario relate to abusive trade practices, which ranks fourth of ten in Manitoba.

- Differences across jurisdictions in respect of the frequency with which criminal cases are pursued may reflect differences in the laws, frequency of financial crime, detection rates, and propensity to pursue criminal as opposed to other types of proceedings. A similar problem of making "apples to oranges" comparisons arises when comparing relief across jurisdictions. Bearing these caveats in mind, total penalties are higher in the U.S. compared to Canada. This is almost entirely due to large restitution payments that are available in the U.S. Administrative penalties and fines alone are comparable, on average, between Canada and the U.S.

2. The extent to which enforcement *requirements* differ regionally is a separate issue from whether effective enforcement *activity* needs to be implemented locally. The two issues are frequently conflated. There is general acceptance that implementing an effective enforcement regime requires a local presence. This still leaves open the extent to which enforcement priorities should differ between regions, such that different rules and regulations are required.

3. Differences in various socio-economic factors (such as per capita disposable income, income distribution of investors, particularly those over age 65, and distribution of firms by size) between provinces explain only some of the difference in per capita investigations between commissions. The link between differences in socio-economic factors and enforcement activity is stronger in the U.S. than in Canada. In light of this,

any securities enforcement regime in Canada needs to be responsive to relevant local conditions. Responsiveness to local conditions for enforcement need not mean that there is no benefit to be derived from adopting a more centralized or harmonized regulatory structure.

4. While in the past, it was not uncommon to have parallel investigations by several commissions into the same or similar conduct this is no longer the case today. The commissions have vastly increased the level of enforcement cooperation and coordination between themselves and with the SROs. While this has meant many of the considerable problems of the past no longer occur today, it has not resolved all issues.

   - The number of cases pursued concurrently by more than one regulator is small as a percentage of total cases (estimated to be less than 5%) although these cases are typically the highest-profile cases.

   - From the regulators' perspective, their efforts to coordinate amongst themselves, appoint a lead regulator or pursue a joint investigation, minimizes any potential jurisdictional conflict or unnecessary duplication.

   - Nonetheless, it is the general view of many securities litigators that Canada's multiplicity of regulators continues to add unnecessary cost to the enforcement process.

     - Parties under investigation do not always have assurance that a settlement reached with one regulator will be sufficient for all, yet they may be limited initially to dealing only with the lead regulator.

     - Joint hearings necessarily entail various coordination costs that would be avoided with a single regulator.

     - Compartmentalization of investigations into components that allow several regulators to play a role is neither efficient nor timely.

   - Whatever the extent of coordination and cooperation, the very structure of the current regulatory regime in Canada today is likely to result in sub-optimal enforcement relative to any regulator that operates from the view of maximizing national interests. There is no mandate for any commission to act in the national interest. Each rightfully operates in its own provincial interest. While some might subsume such interests or take into account the possible effects of their actions outside of their own jurisdiction there is no reason to believe that this will happen as consistently or effectively as would exist with a national regulator.

5. There are moderate economies of scale in enforcement, such that certain savings could be achieved if the fixed costs of having an enforcement branch were incurred once rather than multiple times.

   - The extent of savings from avoiding duplication of fixed costs in respect of enforcement is considerably less than the potential savings available from

consolidating other securities regulatory activities. The lower economies of scale in respect of enforcement compared to policy-making and administrative functions reflect the localized nature of securities enforcement.

- Assuming the new regulatory structure has one head office in Ontario and five branch offices in British Columbia, Alberta, Manitoba, Quebec and Nova Scotia, the economies of scale savings in enforcement are estimated to be $1.8 million annually, which is 8% of the amount that is currently spent by the 13 commissions on enforcement. The savings available from consolidating non-enforcement regulatory activities along the lines of this regulatory structure are estimated to be $44.8 million, or 42% of the amount currently spent by the 13 commissions on non-enforcement activity.

- Our estimated total annual savings in improved economies of scale from moving to the regulatory structure noted above are robust to various sensitivity tests, ranging from an average lower bound of $16 million to an average upper bound of $57 million.

Policy Recommendations

While the commissions have made great efforts to reduce duplication and overlap between themselves and with SROs in enforcement, their principal solutions – joint investigations and appointment of a lead regulator – have not eliminated all costs inherent in a system of multiple regulators. In light of our analysis, we offer the following policy recommendations:

- Of the models being considered to resolve the identified problems due to the multiplicity of regulators, a national regulator with multiple branch offices would be more economical for regulators, intermediaries and issuers compared to the current system while also incorporating regional interests and allowing for local enforcement.

- Any new regulatory structure should recognize that enforcement has a strong local component, both in terms of implementation and allocation of resources.

- As the potential savings from economies of scale of moving to a single regulator are smaller for enforcement than for other regulatory activities, a model that is able to retain the efficiency benefits from centralizing other regulatory activities should allow for relatively decentralized enforcement to the extent possible.

- While the economies of scale savings in enforcement are modest, the estimated savings in non-enforcement budgets of moving to a model with a national regulator and multiple branch offices dwarf total current enforcement budgets. As a result, these non-enforcement savings should factor prominently in considering reform options.

- Moreover, any move to increased centralization of regulators will also eliminate or greatly reduce the current differences between commissions in enforcement activity that are unexplained by differences in socio-economic conditions.

Securities Enforcement in Canada:
The Effect of Multiple Regulators

1. Enforcement Activity Levels

We obtained data from each of the 13 Canadian securities commissions, the IDA and RS. As well, we obtained data from the SEC and a cross-section of U.S. state regulators (Alaska, Colorado, Connecticut, Idaho, Missouri, Kansas, Ohio, Oregon, Pennsylvania, Texas and Wyoming).

There are differences between commissions in respect of the data that they maintain and the period over which such data is available. Table 1 describes the data received from each Canadian commission, the IDA and RS. Table 2 describes the data received from the SEC and the various U.S. state regulators.

Table 1: Description of Canadian Data

Regulator	Data Provided
Alberta Securities Commission	• Enforcement budget, 2000-2002. • Investigations, hearings, provincial court cases, and penalties 2000-2002.
British Columbia Securities Commission	• Enforcement budget, 1997-2002. • Investigations, settlements, hearings, penalties, and criminal cases 1996-2002.
Manitoba Securities Commission	• Enforcement employees and budget 2002-2003. • Investigations and penalties 1999-2002. • Breakdown of investigations by type.
New Brunswick Securities Administration Branch	• Investigations data 2000-2001.
Securities Commission of Newfoundland & Labrador	• Enforcement budget for 2002. • Investigations 2001-2002.
Northwest Territories Securities Registry	• Number of enforcement employees 2002. • Number of registrants 1995-2002.
Nova Scotia Securities Commission	• Enforcement budget 2002. • Investigations and penalties 2002.
Nunavut Securities Registry	• Enforcement budget 2002. • Investigations, firms registered in Nunavut 2002.
Ontario Securities Commission	• Enforcement budget 2000-2002. • Investigation, quasi-criminal cases, and monetary penalties 1997-2002. • Breakdown of investigations by type 1998-2002.
Prince Edward Island Securities Registry	• Enforcement employees 2002. • Investigations, prosecutions, and settlements 1998-2002.
Commission des valeurs mobilières du Québec	• Enforcement budget 1998-2002. • Investigations 1993- 2002. • Hearings, and penalties 1998-2002.
Saskatchewan Securities Commission	• Enforcement budget 2002. • Investigations, penalties, and prosecutions 1992-2002.
Yukon Securities Registry	• Information on the handling of investigations 2002. • Number of salespersons and brokers registered 2002.
Investment Dealers Association	• Number of employees devoted to enforcement 2000-2002. • Number of complaints, investigations, and prosecutions from 2000-2002.
Market Regulation Services	• Information provided on budget and employees 1998-2002. • Data on investigations from Toronto and Vancouver office from 1998-2002. • Data on joint investigations from 1998-2002.

Table 2: Description of U.S. Data

Regulator	Data Provided
Alaska Division of Securities	• Data on enforcement budget and employees 2002. • Annual number of investigations 2002.
Colorado Division of Securities	• Data on enforcement budget and employees 2000-2002. • Annual number of investigations 2000-2002.
Connecticut Division of Securities	• Number of employees devoted to enforcement 2002. • Number of investigations and actions 1999-2002.
Idaho Securities Bureau	• Number of employees devoted to enforcement 1999-2002. • Number of actions and monetary penalties from 1999-2002.
Kansas Office of the Securities Commissioner	• Data on budget devoted to enforcement 1999-2002. • Number of investigations and fines imposed 1999-2002.
Missouri Securities Division	• Number of employees devoted to enforcement 2002. • Number of investigations and criminal cases from 2000-2002.
Ohio Division of Securities	• Number of enforcement employees 1999-2002. • Data was given for the number of investigations, complaints, criminal cases from 2000-2002.
Oregon Division of Finance and Corporate Securities	• Number of employees devoted to enforcement 2002. • Number of complaints, and investigations from 2000-2002.
Pennsylvania Securities Commission	• Number of employees devoted to enforcement 2002. • Number of complaints, investigations, and enforcement actions 1998-2002.
Texas State Securities Board	• Number of enforcement employees and the enforcement budget 1999-2002. • Number of investigations and monetary penalties 1999-2002.
Wyoming Securities Division	• Enforcement budget and the number of employees devoted to enforcement 2002. • Number of investigations and monetary penalties from 1998-2002.
Securities and Exchange Commission	• Number of investigations 1999-2002. • Number of employees devoted to enforcement 2001.

As is evident from Tables 1 and 2, we are unable to make complete comparisons across commissions and SROs in respect of their enforcement activity due to a lack of comparable data. In addition, there may be varying definitions used for some of the variables across commissions. For the most part we focus on the more aggregate data, such as the number of investigations and the number of enforcement staff, where definitional issues are less pronounced. Where we have more detailed information from certain commissions and SROs, we report these recognizing that such comparisons are inherently more anecdotal. In this vein, we provide information on the number of complaints, the number of settlements and the size of monetary penalties imposed where this is available. We also provide any information we have on the type of investigations undertaken, including the extent to which criminal actions are pursued. Finally, some commissions provided data on the number of case referrals and information on concurrent investigations with other jurisdictions.

Quite apart from the difficulties comparing jurisdictions, there are also instances where comparisons over time for any single jurisdiction are complicated by changes in reporting methods. For example, the British Columbia Securities Commission (BCSC) adopted a risk-based enforcement system during the period over which we have data. This change resulted in a considerable reduction in the number of cases that were transferred into their case assessment unit after 2000. The result is that the number of reported investigations drops dramatically in fiscal year 2000-2001. Quebec also had changes over the period. In February 2003, legal specialists, employees of the Registration Department and some employees of the SRO Department were moved to another division of the Commission des valeurs mobilières du Québec (CVMQ), and as a result the number of employees noted for enforcement activity for the CVMQ in 2002-2003 is not directly comparable to the number in earlier years.

Generally, more comprehensive data was provided by the SROs, in particular RS. RS provided detailed data on their surveillance, investigation and enforcement statistics by office (Toronto and Vancouver) as well as details of joint investigations conducted with commissions and other SROs. The IDA provided information on the number of employees devoted to enforcement, the number of investigations, complaints and prosecutions broken down by type. A further breakdown of the number of complaints by province was also provided.

(a) ***Resources Dedicated to Enforcement***

Using the information noted above, we describe the extent to which enforcement activity differs between jurisdictions, focusing on quantitative measures of enforcement activity such as the number of investigations and the size of penalties and settlements.[2] Our goal at this stage is simple documentation. We investigate possible socio-economic explanations for the differences in activity levels later.

Of the 13 commissions, several have very few staff.[3] As a result, staff must cover many activities. In such circumstances, we do not have a good sense of the percentage of time dedicated to enforcement relative to all other activities nor do we have a separate budget item for enforcement activity. As a result, we do not include New Brunswick, Northwest Territories, Nunavut or the Yukon in our comparisons.

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2 A more detailed analysis of the differences in the distribution of the types of cases as well as an identification of the legal drivers behind decisions is provided in Mary Condon, "The Use of Public Interest Enforcement Orders by Securities Regulators in Canada" (WPC Research Study, 2003) at Appendix 1.

3 For example, Nunavut has a total of two staff in its securities area, while the Northwest Territories has three staff.

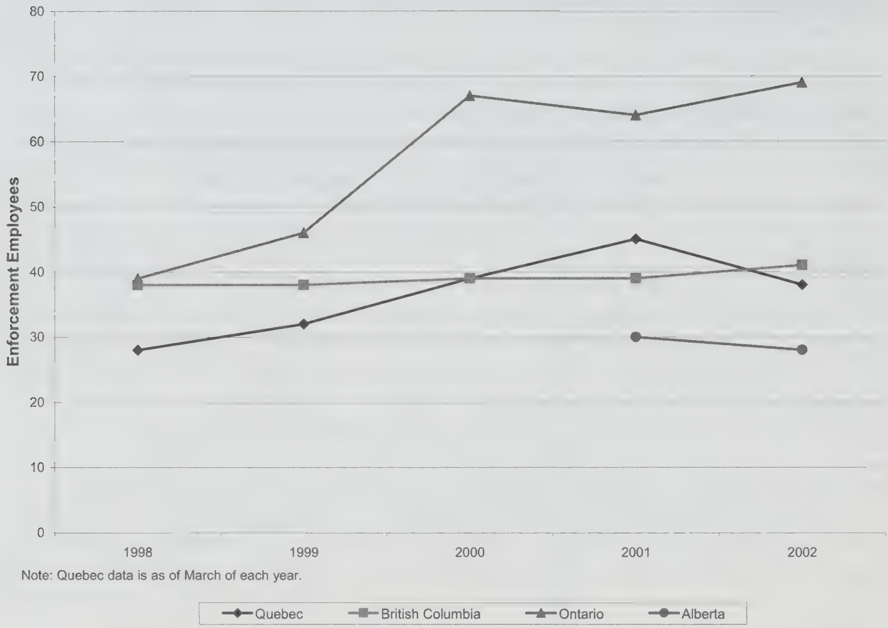
Enforcement budgets are largely related to the number of staff dedicated to enforcement activity. This strong relationship between staff and budget allows us to estimate enforcement budgets using information on total staff and enforcement staff together with data on total budgets where we were unable to obtain actual enforcement budgets from commissions. Table 3 below provides the actual enforcement budget for those commissions where we have this information, and the imputed enforcement budget (calculated as the percent of labour in enforcement multiplied by the total budget).

Table 3: Actual Enforcement Budgets versus Imputed Enforcement Budget

Commission	Actual Enforcement Budget 2002 CDN$(000's)	Imputed Enforcement Budget CDN$(000's)
Alberta	$3,084	$3,757
Newfoundland	$50	$64
Saskatchewan	$230	$234
Ontario	$9,225	$10,704
Nova Scotia	$124	$95
British Columbia	$3,456	$2,897
Manitoba	$400	$436
Quebec	$4,418	$4,615
Texas	$1,778	$2,607
Wyoming	$375	$406
Colorado	$1,902	$1,530

For those commissions that provided data over time, Figure 1 graphs the number of enforcement staff over time.

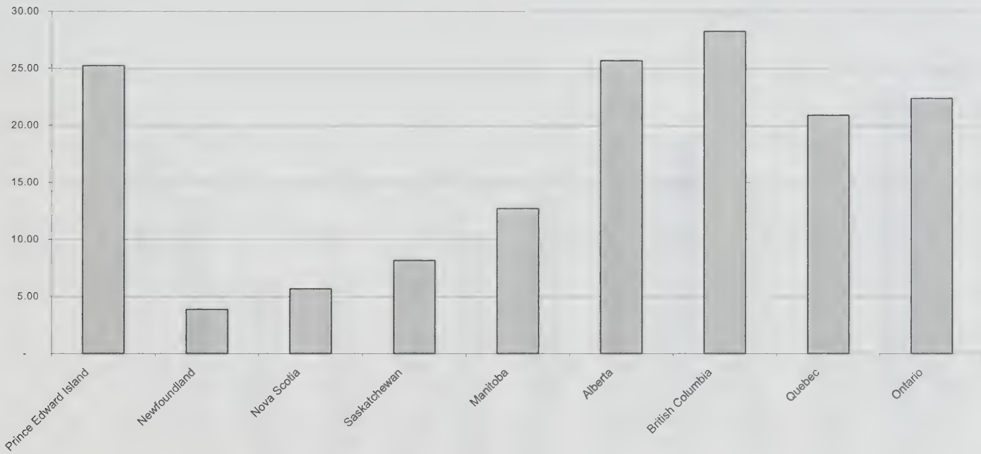
Figure 1: Securities Enforcement Staff Over Time



Both Ontario and Quebec have significantly increased their enforcement resources. The change in Ontario's enforcement resources is remarkable, increasing 77% between 1998 and 2002. In contrast, enforcement staff numbers in Alberta and British Columbia have remained relatively constant over time.

Figure 2 shows the total enforcement budget across commissions relative to GDP for the most recent fiscal year.[4] Note that the enforcement budget for Prince Edward Island (PEI) is calculated using the share of employees dedicated to enforcement as described above. All other commissions report actual enforcement budgets, with the exception of Quebec, which reports enforcement expenditures.[5] The provinces are ordered from smallest to largest.

Figure 2: Canadian Enforcement Budgets per CDN$1 million of GDP



Apart from PEI, enforcement budgets are significantly larger for the bigger provinces.[6] Among the largest four provinces, Alberta and British Columbia have greater enforcement budgets relative to GDP compared to Quebec and Ontario.[7] This may reflect the fact that Quebec and Ontario benefit from scale economies.

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4 The most recent fiscal year is 2002-03 unless otherwise indicated. The most recent data for Manitoba, Newfoundland and Prince Edward Island are for 2002. As described above, the commissions without data on dedicated enforcement staff or budgets are excluded (New Brunswick, Northwest Territories, Nunavut and the Yukon).

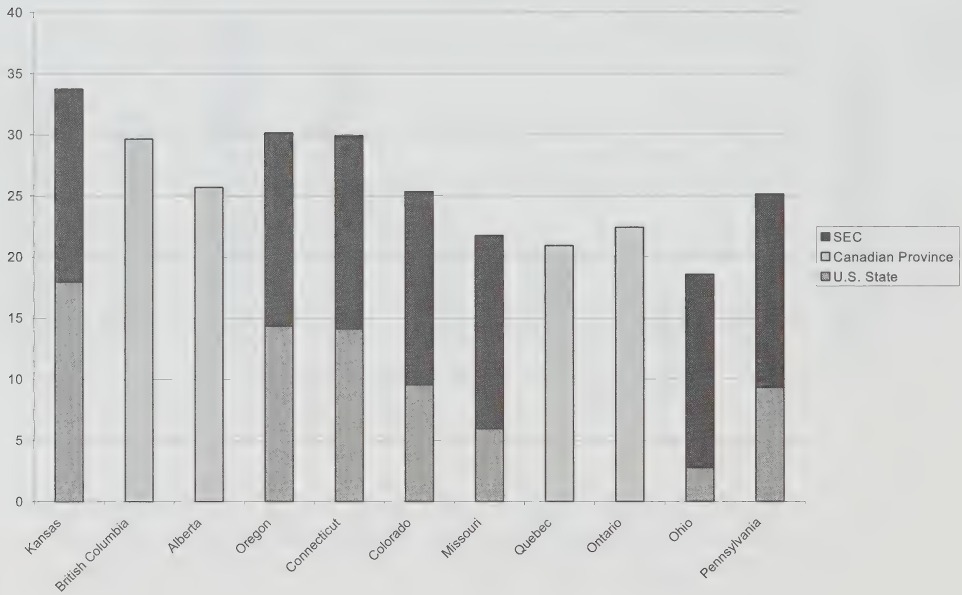
5 We are informed by officials at the CVMQ that the budget allocated to enforcement generally matches expenditures related to enforcement.

6 The same is true if per capita enforcement budgets are compared across commissions.

7 The same is true if per capita enforcement budgets are compared across commissions.

For comparison purposes, Figure 3 shows enforcement budgets (in Canadian dollars) relative to GDP for the SEC together with U.S. states of comparable size to the larger Canadian commissions in 2002.[8] We include the four largest Canadian commissions for comparison purposes. Once again, the jurisdictions are ranked from smallest to largest. In general, there are higher expenditures on enforcement in the U.S. compared to Canada.[9]

Figure 3: Canadian and U.S. Enforcement Budgets per CDN$1 million of GDP



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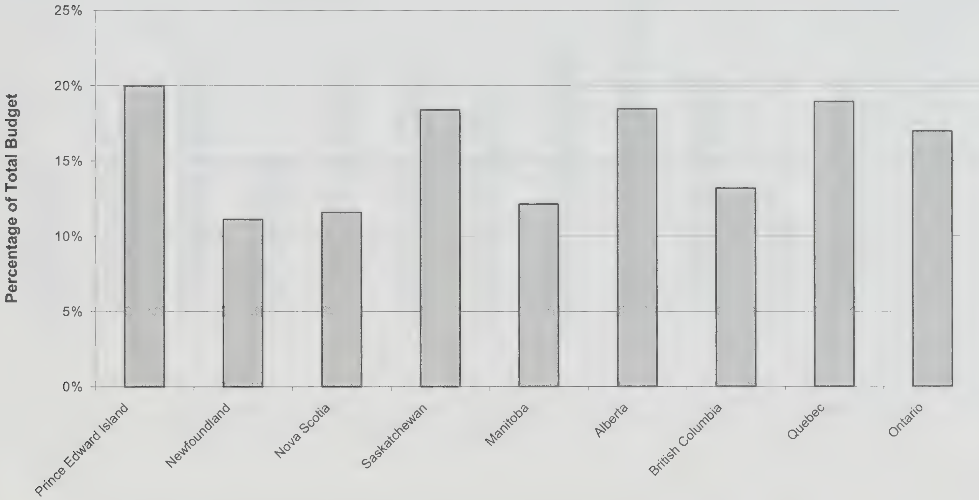
8 The figures reported for Colorado and Kansas are fiscal year 2002-03. Actual enforcement budgets were provided for Alaska, Colorado, Texas and Wyoming. The remaining states' and the SEC's enforcement budgets were calculated by multiplying the percentage of personnel dedicated to enforcement and the total budget.

9 The same is true if per capita enforcement budgets are compared across commissions.

Figure 4 expresses each Canadian commission's enforcement budget as a percentage of its total budget in the most recent fiscal year. There is variation across provinces, without any clear relationship between jurisdiction size and the percentage of the total budget dedicated to enforcement. Among the larger commissions British Columbia has a smaller budget share dedicated to enforcement compared to Alberta, Ontario and Quebec.

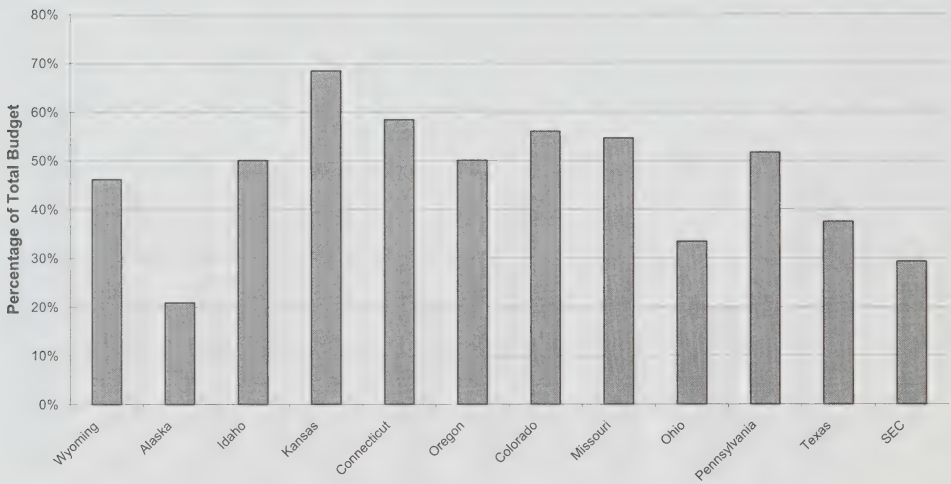
Figure 4: Canadian Enforcement Budgets as a Share of Total Budget



Note: Figures for PEI, Newfoundland, and Manitoba are for 2002. Enforcement budget for PEI is allocated based on enforcement personnel as a percentage of the total budget.

Figure 5 provides the U.S. state and SEC enforcement budgets as a percentage of their respective total budgets. In the case of the SEC, the calculation is based on total number of employees dedicated to enforcement relative to total number of employees.

Figure 5: U.S. Enforcement Budgets as a Share of Total Budget



Note: Figures for Colorado and Kansas are for fiscal year 2002-03. Actual budgets are provided for Alaska, Colorado, Texas and Wyoming. The remaining states' and SEC budgets are calculated as a share of enforcement personnel to total budget.

Like Canada, there is variation across jurisdictions as to the percentage of the budget allocated to enforcement.[10] The SEC undertakes enforcement activities and also acts as a central policy-maker for securities regulation in the U.S. As a result, it might be expected to devote a smaller percentage of its overall budget to enforcement compared to many U.S. states, in light of the limited policy-making role that state securities regulators perform.

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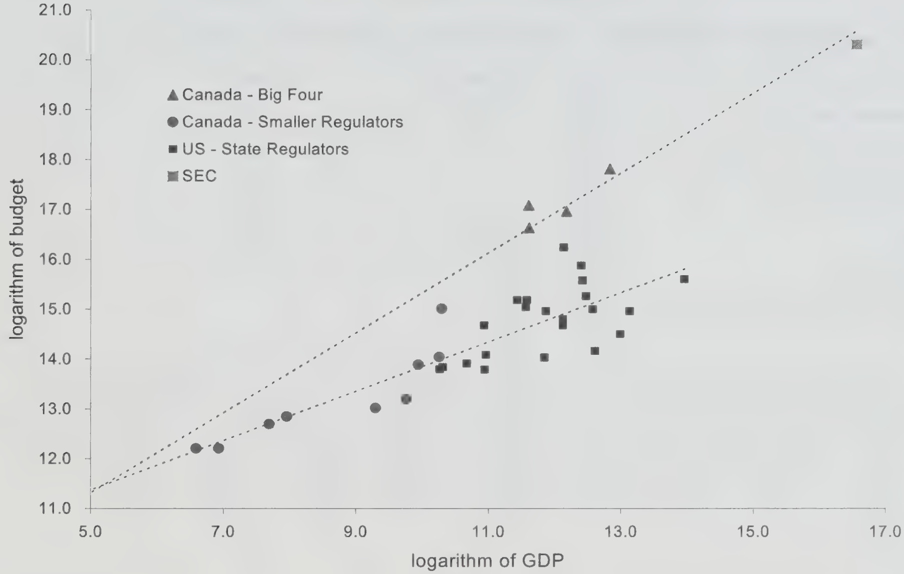
[10] We can calculate a statistic to get a sense of the difference in the degree of variation between the two countries. We first normalize expenditure enforcement shares in each country by dividing each state or province share by the average share for the data in the respective country samples. (We exclude Alaska from the calculations as it differs the most from the average. This does not change our qualitative conclusions.) We then calculate the standard deviation, a measure of dispersion in the data, for each country. The standard deviation is 23% for Canada and 17% for the U.S. states. The higher standard deviation in Canada suggests that there is more variation in Canada compared to the sample of U.S. states. However, the difference is not statistically significant which here practically means that if we used a second U.S. sample of states there is a reasonable likelihood that the measured difference would disappear.

Figure 6 shows a plot of total securities operating budget against GDP (in logarithms) for Canadian commissions, the SEC and the various U.S. states.

Figure 6: 2002 Operating Budgets and GDP by Jurisdiction



As evident from Figure 6, the primary securities regulators in Canada are more like the SEC, while the smaller provincial commissions are similar to the U.S. state commissions. Nonetheless, a comparison of Figures 4 and 5 indicates that the larger Canadian commissions devote considerably less of their total budget to enforcement than does the SEC.

Additional Detail on Enforcement Staff Allocation

A breakdown of enforcement staff by function is only available for Alberta and Ontario. Both commissions provided us with three years of data. Table 4 reports the allocation of enforcement staff by function, averaged over 2000-2002. (Note that the percentages do not add to 100% due to rounding.)

Table 4: Allocation of Enforcement Labour Resources, 2000-2002 Average

	Alberta	Ontario
Case Assessment	27%	20%
Surveillance*	—	16%
Investigation	37%	39%
Litigation	29%	20%
Director's office	7%	6%

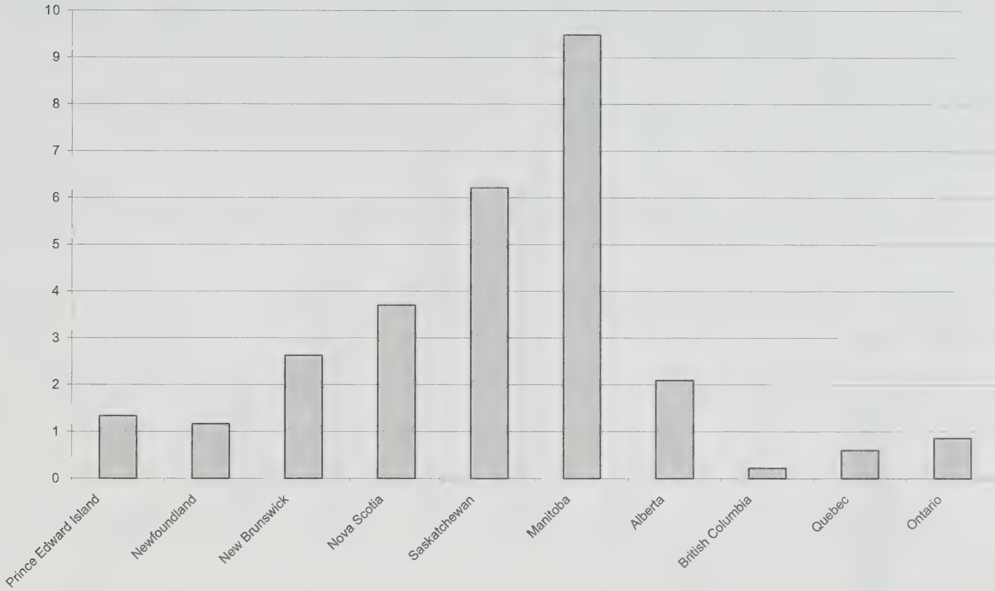
* Alberta does not separate out surveillance functions

Both Commissions devote similar resources to investigation and the director's office. Ontario devotes more of its enforcement resources to case assessment and surveillance while Alberta devotes more of its enforcement resources to litigation. Notwithstanding the differences that exist between Alberta and Ontario in respect of total resources dedicated to securities enforcement, the division of the available resources by function is similar.

(b) *Enforcement Outputs*

Having examined differences in inputs dedicated to enforcement, we turn next to measures of outputs.[11] [12] Figure 7 shows the most recent year's number of securities investigations per CDN$1 billion of GDP for ten commissions.[13] We include New Brunswick as we have available data.

Figure 7: Canadian Investigations per CDN$1 billion GDP



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[11] In the final analysis, the *outcome* that is important is promoting the "public interest" by pursuing capital market integrity, fairness and efficiency. Our focus in this section is on *outputs* of securities regulators, which are much easier to measure but may not all be closely correlated with the above outcomes.

[12] One of the main objectives of enforcement activity is deterrence. While this is one of the critical objectives, it is very difficult to measure deterrence effects of enforcement activity. Two fundamental problems arise. First, it is often impossible to identify the impact of greater enforcement resources on the incidence of crime when enforcement resources and crime rates potentially move together. To illustrate, it is often the case that areas of high crime have high numbers of police compared to areas of low crime because authorities allocate more police to areas where crime is higher. This makes it difficult to determine the extent to which increasing the number of police leads to less crime unless one can identify exogenous changes in enforcement levels and track their effects over time. Second, it can be very difficult to separate out the effect of greater enforcement resources on detection rates from the underlying crime rate. For instance, an increase in the number of police may lead to greater numbers of crimes being detected or reported as victims are more likely to report crimes if police are responsive and have the resources available to properly investigate crimes. This problem is especially acute in economic crimes where, in comparison to other types of crimes, detection levels are highly responsive to the level of enforcement activity.

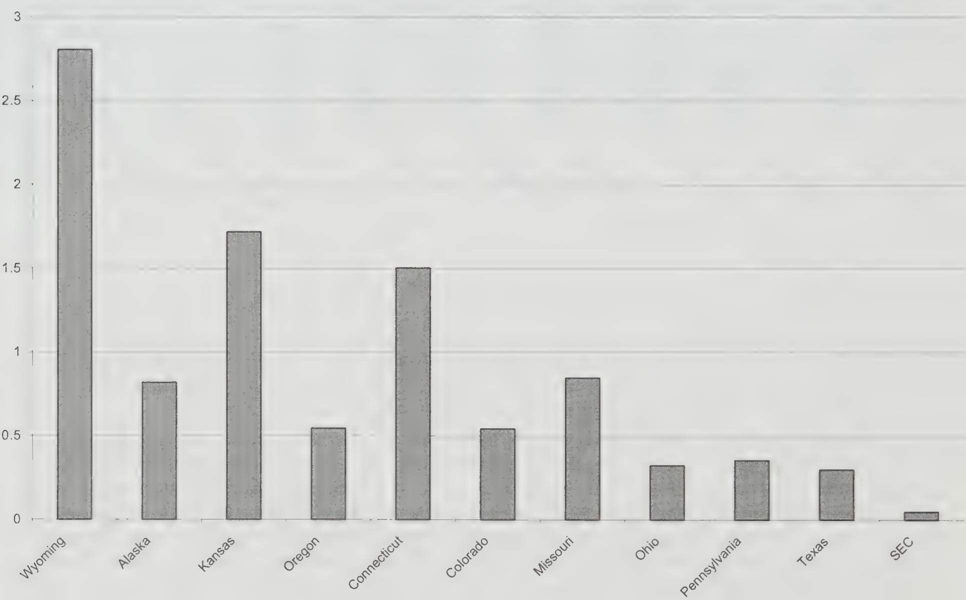
[13] This is either fiscal year 2002-03 or 2002 as noted above.

Among the smaller jurisdictions, there is a very strong positive correlation between the number of investigations and GDP.[14] This relationship is clearly broken for the larger provinces. One possible explanation for the differences between the larger and smaller commissions is the use of screening systems in the larger commissions to prioritize cases. This has the effect of reducing the number of cases that are advanced to the investigation stage.

Among the larger provinces, British Columbia has a very low number of investigations relative to GDP (and per capita). This is likely related to a change in the BCSC's screening system, which came into effect in 2001. As a result, the number of cases that reach the BCSC's case officers, which are counted as investigations, has fallen substantially. If we use the number of investigations prior to this change, the number of investigations relative to GDP in British Columbia is very similar to that in Ontario.[15] We examine below whether differences in socioeconomic factors between provinces can explain much of the variation in the investigation rate.

Figure 8 below provides the number of investigations per CDN$100 million of GDP for the U.S. states and the SEC.

Figure 8: U.S. Investigations per CDN$1 billion GDP



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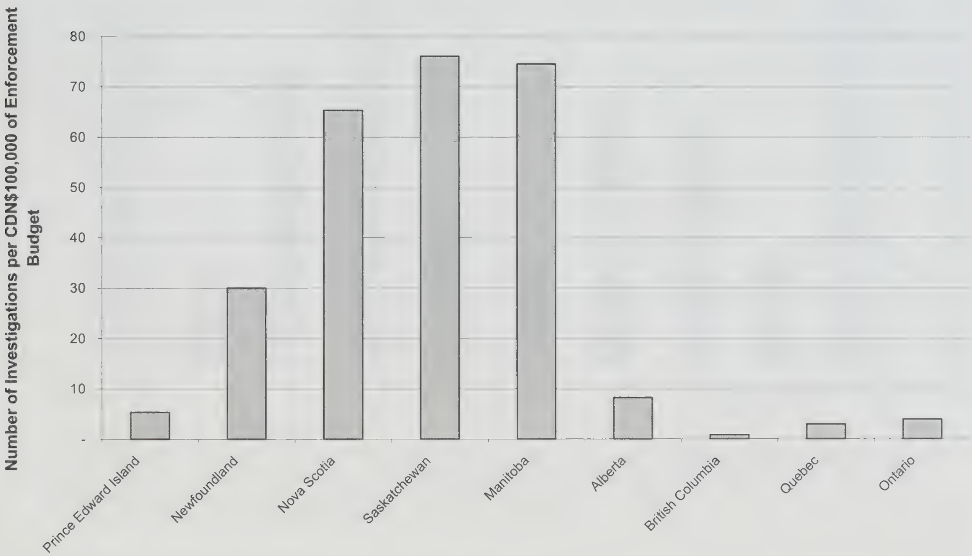
[14] The same is true if per capita investigations are compared across commissions.

[15] The same is true if per capita investigations are compared across commissions.

Among this group, we find considerable variation among the smaller states but greater uniformity among the larger states. Comparing Figures 7 and 8, the numbers of investigations relative to GDP for the larger Canadian provinces are generally comparable to the larger U.S. states.

Figure 9 below provides the number of investigations per CDN$100,000 enforcement budget for the Canadian commissions for which we have available data.

Figure 9: Canadian Investigations per CDN$100,000 Enforcement Budget

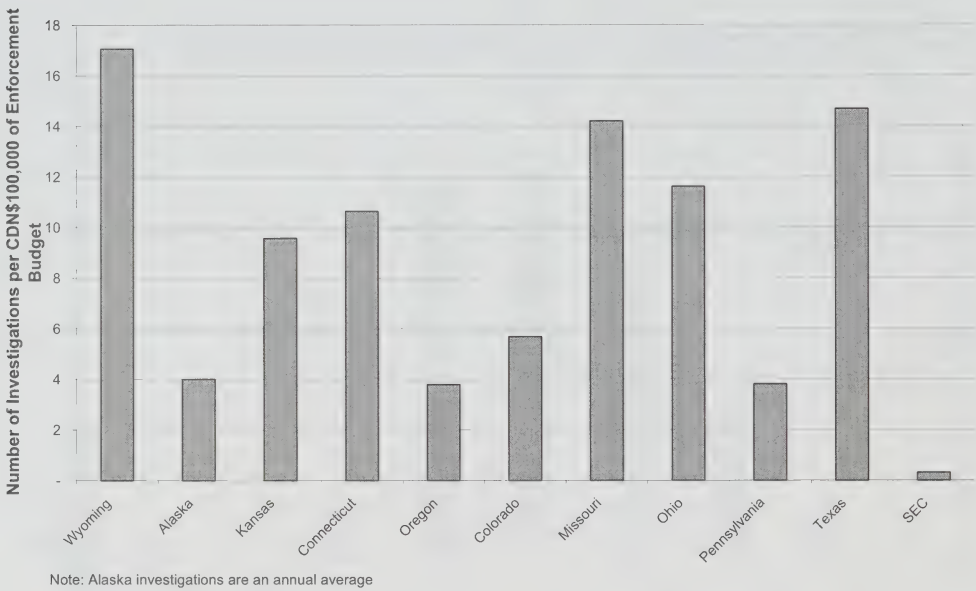


Note: Prince Edward Island investigations are an annual average.

Figure 9 shows a dramatic difference between the large and small commissions. We expect the differences to reflect the use of formal screening systems by the larger four commissions – larger commissions focus on larger cases and hence have fewer investigations. Among the larger provinces, Alberta has the highest number of investigations per CDN$100,000 enforcement budget.

Figure 10 below presents the number of investigations per CDN$100,000 enforcement budget for the U.S. states and the SEC.

Figure 10: U.S. Investigations per CDN$100,000 Enforcement Budget



Like the larger Canadian commissions, Figure 10 reveals considerable variation between the larger U.S. states. Among the U.S. states considered here, there are no clear differences between large and small states.

The RS data provides another perspective on potential differences between regions. Between 1998 and 2002 there were on average 35.8 RS investigations closed per year for the TSX and 118 RS investigations closed per year for the Venture Exchange. There are about 1.9 times more firms listed on the TSX Venture Exchange than on the TSX so that the rate of investigation is substantially higher for TSX Venture Exchange firms.[16]

[16] Based on the number of firms listed on each exchange in the spring of 2003, the investigation rate is about 4.8% for TSX Venture Exchange-listed firms and 2.8% for TSX-listed firms.

Additional Detail on Resolution of Investigations

We have some additional detail on the number of complaints received, investigations launched and their outcome for the four large commissions, reported in Table 5 below. For each province we also present the number of complaints received by the IDA. As not all commissions maintain the same set of data, we do not have comparable statistics on all classifications.

Table 5: Average Complaints, Investigations and Proceedings per CDN$10 billion GDP, 2000-2002

	Ontario	Quebec	Alberta	B.C.
IDA Complaints*	13.94	4.03	9.66	22.19
Commission Complaints	19.75	7.96	60.54	–
Investigations	8.70	6.14	19.36	**
Settlements	–	–	1.70	1.45
Hearings	0.65	1.61	–	2.18
Criminal Cases	0***	–	0.20***	0.12***
Monetary Penalties	$159,873*	$53,007	$16,614	$160,316

* Average is only for 2001 and 2002.

** British Columbia Investigations are excluded because after moving to risk-based enforcement the number of investigations is not comparable to the other large commissions.

*** Figures for Ontario and Alberta are for Provincial Court proceedings. British Columbia figures represent criminal prosecutions where charges were laid.

Several points may be drawn from Table 5. Taking the ratio of investigations to complaints, we find Quebec has the highest percentage of its complaints become investigations – at 77% – while Alberta has the lowest at 32%. Ontario has 44% of its complaints become investigations. We note that these differences may be entirely related to definitions. British Columbia has the largest number of hearings, followed by Quebec and Ontario, once scaled for GDP. Monetary penalties, which encompass fines, administrative penalties, settlement proceeds, cost awards and restitution are comparable in Ontario and British Columbia, and are several times larger than those in Alberta and Quebec once account is taken of GDP differences. Note that not all regulators will have had all of these powers over 2000-2002. While Alberta has the highest number of investigations relative to GDP, its monetary penalties relative to GDP are the lowest perhaps due to the mix of cases it took over 2000-2002.

Table 6 below provides information on the outcome of complaints to the IDA.

Table 6: IDA Activity Annual Averages for 2000-2002

	Annual Average	Per CDN$10 Billion GDP
Complaints	1,125	11.8
Investigations	181	1.9
Prosecutions	210	2.2

In terms of the type of investigations undertaken, we have some comparable information on criminal cases and penalties from several jurisdictions; notably, Alberta, British Columbia and Ontario in Canada; and Connecticut, Idaho, Missouri, Ohio, and Pennsylvania in the U.S.[17] Table 7 below summarizes the frequency of criminal securities cases relative to GDP and relative to total securities investigations.

Table 7: Criminal Securities Cases, Annual Average 2000-2002

	Criminal Securities Cases	Criminal Cases as a percent of all Investigations	Criminal Securities Cases per CDN$10 billion GDP
Alberta	2.33	1.0%	0.20
British Columbia	1.33	5.4%	0.12
Ontario	0.00*	0.0%*	0.00*
Connecticut	5.67	2.1%	0.30
Idaho	1.00	N/A	0.22
Missouri	5.00	3.3%	0.24
Ohio	5.33	3.0%	0.12
Pennsylvania	2.00	1.3%	0.04

* While there were no criminal cases in Ontario during 2000-2002, there were six criminal securities cases in Ontario in 1999 out of a total of 359 investigations that year.

Differences across jurisdictions in respect of the frequency with which criminal cases are pursued may reflect differences in the laws (i.e. criminal proceedings may not be available), the frequency of financial crime, detection rates, and the propensity to pursue criminal as opposed to other types of proceedings. Thus, where civil penalties include injunctive relief and large penalties- monetary and otherwise – there may be fewer criminal cases pursued.

17 Some states, such as Texas, report total number of individuals convicted rather than total number of criminal proceedings, and hence we exclude Texas from the comparison.

A similar problem of "apples-to-oranges" comparisons arises when comparing penalties across jurisdictions. Monetary collections from enforcement actions can include fines or administrative penalties, settlement proceeds, cost awards and restitution. Not all regulators have equal powers in these respects. Bearing this caveat in mind, Table 8 below presents fines and administrative penalties per CDN$1 billion GDP for the Canadian commissions and U.S. regulators for which we have data. It is important to bear in mind that some of the differences revealed in Table 8 may result from different legal frameworks. For example, not all commissions have equal opportunity to pursue criminal penalties[18] nor can all seek administrative monetary penalties.[19]

Total penalties are higher in the U.S. due to large restitution payments. Administrative penalties and fines are comparable, on average, between Canada and the U.S. However, when account is taken of SEC civil penalties and disgorgements of illegal profits along with U.S. state restitution, U.S. monetary penalties are ten times larger than average Canadian penalties, per CDN$10 billion GDP.

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18 AssetRisk Adivsory Inc. in a report studying best practices in enforcement noted in comparing the OSC, BCSC, SEC and FSA (Financial Services Authority in the U.K.) that "financial crime does not have a high profile with government or police in Canada, unlike in the United Kingdom and the United States, and therefore regulators in Canada do not have the option of ready access to the criminal justice system with respect to securities fraud." (p. 8). AssetRisk Advisory Inc., *Best Practices in Capital Markets Enforcement* (2002).

19 For an enumeration of the penalties available to different commissions, see Mary Condon, "The Use of Public Interest Enforcement Orders by Securities Regulators in Canada" (WPC Research Study, 2003) at Appendix 1.

Table 8: Breakdown of Penalties per CDN$10 billion GDP (All figures are annual averages for the years where data was available)

Commission	Admin. Penalties / Fines	Costs	Restitution/ Disgorgement	Total	Number of Years with Available Data
Alberta	$11,592*	$5,022		$16,614	3
British Columbia				$157,624***	8
Manitoba	$17,113*	$13,078		$30,190	4
Nova Scotia		$457		$457	1
Ontario	$150,636*	$9,237**		$159,873	2
Quebec	$52,179*	$1,162		$53,340	4
Saskatchewan	$5,960	$960		$6,920	11
Canada**	**$93,418**	**$6,188**		**$104,302**	
Alaska	$65,303			$65,303	5
Connecticut	$39,492		$203,092	$242,584	4
Idaho	$15,365	$1,381	$281,189	$297,934	4
Kansas	$30,620		$17,560	$48,180	3
Missouri	$55,641		$3,398	$58,859	1
Texas	$2,716		$664,326	$667,042	4
Wyoming	$60,801	$1,726	$331,697	$394,224	5
SEC	$101,495		$767,509***	$869,004	4
U.S.**	**$119,865**	**$1,493**	**$1,230,467**	**$1,333,887**	

* Settlement payments are included for these provinces. For Ontario, the average settlement payments for 2000-2002 were $2,925,000.

** Based on data for the indicated provinces and states, weighted by population. Blank entries are not counted as zeroes in computing the averages. The SEC cost per population is added to the population averages for the states.

*** Disgorgements of illegal profits.

Additional Detail on Types of Cases Pursued

Of the Canadian commissions, only Ontario and Manitoba were able to provide the type of investigations (e.g., trading without registration or sale of unregistered securities) over time. As each province uses different grouping criteria we aggregated the data in order to make comparisons across the two jurisdictions. Table 9 reports the data for 2002.

Table 9: Details on Types of Investigations, 2002 (percent of all investigations)

	Manitoba	Rank	Ontario	Rank
Sale of Unregistered Securities	13.8%	1	4%	7
Fraud / Theft	6.7%	2	5.4%	5
Abusive Sales Practices & Misconduct	6%	3	17%	2
Abusive Trading Practices	3.4%	4	24.2%	1
Trading without Registration	3%	5	14.4%	3
Non-Disclosure / Misleading Disclosure	1%	6	4.5%	6
Assistance-Law Enforcement	0.34%	7	2.5%	8
Takeover Bid Issues	0%	8	0.6%	10
Assistance to other Commissions and Branches	0%	8	6.8%	4
Non-Compliance with Commission Orders	0%	8	0.85%	9
Other	66%		20%	

Manitoba classifies a much larger share of its investigations under "Other". In light of this, it may be more useful to examine the relative ranking of particular types of investigations rather than the absolute numbers. For Manitoba, investigations of sales of unregistered securities rank as the most important category (other than "Other") whereas this category only ranks fourth out of ten for Ontario. In Ontario, investigations of abusive trading practices are the most important category.

The greater emphasis on abusive trading and sales practices in Ontario and sales of unregistered securities in Manitoba is not surprising. Ontario has a large number of public companies, many of which are large, and higher incomes that generate more investing activity and opportunities for misconduct such as insider trading. Manitoba is a much smaller province and therefore must deal with problems more likely to arise with smaller firms, such as selling unregistered securities. As a result, there appear to be few common trends between the two commissions in terms of their types of investigations over time.[20] This is consistent with our discussions with directors of enforcement within the commissions, who indicated that the mix of enforcement activity differs considerably from province to province.

[20] Statistical tests suggest that the investigation type rankings between Manitoba and Ontario are not highly correlated.

Table 10 provides details on the types of investigations pursued by the IDA, while Table 11 provides information on RS investigations.

Table 10: IDA Investigations by Type, Annual Average 2000-2002

Type of Investigation	Annual Average	% of Total
Capital Deficiency	8	4.4%
Churning & Excessive Trading	0	0.2%
Conduct	8	4.2%
Dismissal for Cause / Termination	7	3.9%
Falsification of Information	11	6.1%
Fraudulent Activities	6	3.1%
Inappropriate Dealings	10	5.5%
Internal Control Issues	9	5.0%
Misrepresentation	4	2.4%
Money Laundering	0	0.0%
Service Issues	0	0.2%
Supervision	8	4.6%
Trading Irregularities	7	3.7%
Trading Outside Jurisdiction	0	0.2%
Unauthorized or Discretionary Trading	33	18.2%
Unsuitable Investments	50	27.6%
Violation of Regulator Orders	2	1.1%
Other	17	9.6%
Total	**181**	**100%**

Table 11: RS Investigations by Type, Annual Average 2000-2002

RS Vancouver			RS Toronto		
Type	**Files Opened**	**% of Total**	**Type**	**Files Opened**	**% of Total**
Insider Trading	20.0	31%	Manipulative/Deceptive Trading	11.3	49%
Market Manipulation	12.7	20%	Customer Principal Trade Violation	2.7	11%
Wash Trading	9.0	14%	Supervision	2.0	9%
Active Security Review	4.0	6%	Restriction on Trading	1.7	7%
Conduct Unbecoming	3.0	4%	Insider Trading	1.3	6%
Conflict of Interest	2.7	3%	Conduct Unbecoming	1.0	4%
High Closing	1.3	2%	Front-Running	1.0	4%
Advertising	0.7	1%	Disclosure	0.7	3%
Debit Kiting	0.7	1%	Client Principal Disclosure	0.3	1%
Discretionary Trading	0.7	1%	Normal Course Issue Bid	0.3	1%
Off the Floor	0.7	1%	Registered Trader Responsibilities	0.3	1%
Other	10.0	16%	Unapproved CATS Trading	0.3	1%
			Unregistered Trading	0.3	1%
Total	**64.3**	**100%**	**Total**	**23.3**	**100%**

Table 12 provides details of the SEC's investigations in 2002. As the SEC tracks its investigations differently from those of the Canadian commissions reported above, we are unable to directly compare SEC activity levels with any Canadian regulator.

Table 12: Details on SEC Investigations, 2002

Primary Classification	Total	% of Total Actions
Total Issuer Financial Statement and Reporting Actions	163	27%
Securities Offering Actions	119	20%
Total Broker-dealer Actions	82	14%
Insider Trading Actions	59	10%
Total Other Regulated Entity Actions	54	9%
Contempt Proceedings	47	8%
Market Manipulation Actions	42	7%
Delinquent Filing Actions	10	2%
Touting	13	2%
Miscellaneous Actions	7	1%
Corporate Control Actions	2	0%
Total	**598**	**100%**

2. Local Nature of Enforcement

The mix of cases and importance of enforcement may differ commission to commission to the extent to which regional or local differences in the markets require different enforcement responses. (We note that other researchers retained by the Wise Persons Committee are addressing local and regional aspects of securities regulation as their sole focus of enquiry.)

The more enforcement requires a local presence, and the greater the divergence in needs between regions, the more an enforcement system should lean towards one that has both regional representation and regional autonomy. On the other hand, a system of local autonomous enforcement may create differences in enforcement activity that arise only from the lack of coordination among regulators rather than from true regional differences. Thus, we would like to know not only the extent to which regulation is regional in terms of (ideal) implementation and needs, but also the extent to which separate regulators add their own idiosyncratic influence on enforcement activity that is not attributable, at least directly, to differences between regions.

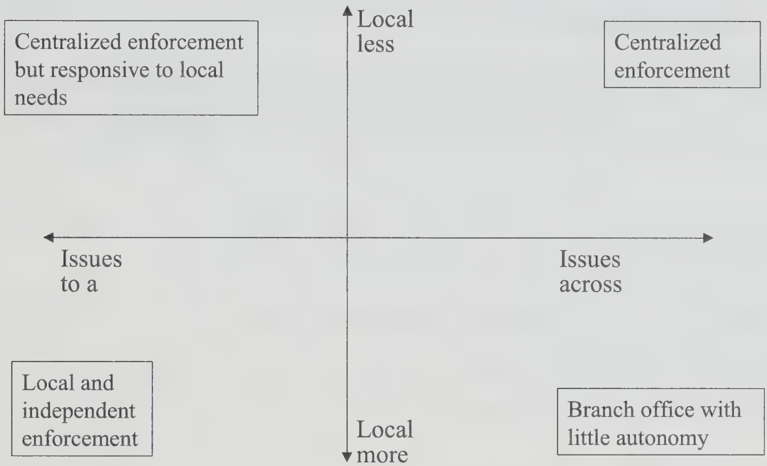
(a) *Local Implementation and Regional Variation*

The extent to which enforcement priorities differ regionally because of regional differences is a separate issue from whether effective enforcement activity needs to be implemented locally. The two issues are frequently conflated. Just because enforcement activity (i.e. gathering evidence by visiting specific company locations) may be best organized locally does not mean that the rules or requirements for such activity (i.e. what constitutes violations of

rules and laws) need be different locally. For example, Canada has a common Criminal Code for the country, with enforcement activity related to it carried out by regional offices of the Attorney General of Canada, and provincial Attorneys General.

Figure 11 below provides a schematic representing these two dimensions. The horizontal axis identifies the extent to which enforcement issues are region-specific, while the vertical axis identifies the extent to which a local presence is important in carrying out enforcement activities.

Figure 11: Schematic of Enforcement Dimensions



In the southwest corner effective enforcement requires a local presence to carry out activities (e.g. investigators gathering evidence, prosecutors building cases, local access to respondents) and sufficient autonomy to develop region-specific rules and regulations. The opposite extreme is in the northeast corner where enforcement can be effectively carried out by a national regulator. In the southeast corner, a local presence is important for carrying out enforcement but the rules and regulations being enforced are largely common. A regional office that carries out enforcement under some direction from headquarters is appropriate. Finally, the northwest corner represents the situation where most enforcement can be conducted from a distance but the regulations need to be tailored to regional needs (this is largely hypothetical, as such a combination is unlikely to arise).

In our discussions with directors of enforcement at several commissions, all indicated that effective enforcement requires a local presence. Indeed, most enforcement activity, whether the law is provincial or federal, is carried out locally using local staff and budgets. Investigators need to be able to gather local intelligence. This requires proximity to react quickly and local knowledge in order to be effective. A local presence also reduces travel costs for witnesses and investigators.

Referring back to Figure 11, securities enforcement appears to be generally located in the southern quadrants where a significant amount of enforcement activity needs to be conducted at the local level. This still leaves open the extent to which enforcement priorities differ between regions, such that different rules and regulations are needed. As well, it leaves open the corresponding degree of autonomy that regional enforcement agencies should have in determining staffing levels and allocations, salaries, enforcement priorities, effort levels for specific investigations and prosecutions, collaboration and coordination with other agencies, and the use of different screening systems. To shed light on these issues, we investigate the extent to which regional socio-economic differences are important for understanding the observed differences in enforcement output.

(b) *Regional Socio-Economic Differences*

Despite Canada's relatively small population, we are a country of considerable economic and social variation. Those economic and social factors that strongly influence the level or type of financial crime (or rule violation) may explain and justify the variation in enforcement activity.

There are various socio-economic factors that may influence the incidence of securities regulatory infractions for a given population size. We focus on the following factors:

- Levels of disposable income;
- Distribution of income and the presence of high-income earners;
- Distribution of age and its interaction with wealth;
- Distribution of firms by size; and
- Distribution of employment by industry.

Higher average levels of disposable income are typically correlated with greater investment activity and larger individual investments. We expect greater investment activity and larger investment amounts would increase the potential benefits to be realized from violating securities laws. As well, we expect greater investment activity and larger investment amounts to be correlated with the number of violations given they imply larger numbers of intermediaries per capita.[21] Similarly, the greater the number of high-income (and high net-worth) individuals within a region the greater is the expected level of financial activity and hence the greater the opportunity for rule violation. On the other hand, high-income individuals are also more likely to be financially sophisticated and thus less vulnerable to frauds and scams. The exception may be those high-income individuals who are elderly who are often the targets of financial crime.

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[21] Not all commissions were able to provide us with data on the number of intermediaries within their jurisdiction. For those that did provide this information, definitions and groupings (e.g. individuals versus firms) of registrants differed sufficiently that we were unable to undertake valid inter-provincial comparisons. Once the National Database of Registration (NRD) is fully implemented for individual and firm registrants, such information will be fully (and consistently) available by province.

Turning to factors related to firms, variation in the types of firms within a region may affect the type and level of enforcement activity. For example, fraudulent financial reporting is much more likely in smaller firms, though the magnitude of any potential fraud is also smaller and the issues may be less complex.[22] Certain industries may also give rise to greater levels of enforcement activity if financial deceptions are more common in particular industries.

In addition to the socio-economic factors identified above, there may be other factors of importance such as investor education or ethnicity. We do not have a sufficiently large and detailed data set of enforcement activity to determine whether these factors either give rise to differences in enforcement activity. As well, it is unclear that there are sufficient differences in the *distribution* of investor education and ethnicity between regions to affect enforcement.

Table 13 below provides statistics by region on the identified socio-economic factors. There is considerable variation from one province to another. Alberta and Ontario are the richest provinces in terms of per capita disposable income while Saskatchewan and the Atlantic provinces are the poorest. British Columbia has a large share of high-income earners and has the highest investment income for those aged 50 to 84. Saskatchewan has the largest share of its population comprised of individuals over the age of 75.

In respect of firm and industry data, the Gini coefficient measures inequality across firms based on market capitalization. The coefficient ranges from zero to one. The closer it is to one the higher the level of inequality (i.e. the more the total market capitalization is concentrated in just a few firms). Alberta and Quebec have the highest level of inequality among firms while Saskatchewan, Manitoba and the Atlantic provinces have the lowest. Finally, we provide statistics on the share of employment in manufacturing and natural resources to capture regional differences in industry composition.[23]

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22 See the Committee of Sponsoring Organizations of the Treadway Commission ("COSO"), "Fraudulent Financial Reporting: 1987-1997 – An Analysis of U.S. Public Companies", online at http://www.coso.org/.

23 The data are gathered from Statistics Canada except for the Gini coefficients, which are derived from Bloomberg data. U.S. data used in the analysis below are from the Census Bureau.

Table 13: Socio-Economic Statistics by Province

	BC	AB	SK	MB	ON	QC	Atlantic
Per capita annual disposable income	$21,097	$24,835	$18,492	$20,866	$23,687	$20,629	$19,260
Population percent with annual income > $100,000	12.1%	10.7%	6.4%	6.7%	14.3%	7.2%	5.3%
Average annual investment income, age 50 – 84	$2,803	$2,735	$2,689	$2,192	$2,548	$1,803	$1,126
Population percent > age 75	6.3%	4.5%	7.7%	7.0%	5.7%	5.7%	6.2%
Gini coefficient for market cap of listed firms	0.89	0.93	0.84	0.78	0.91	0.93	0.83
Share employment in manufacturing	10.0%	8.8%	6.1%	12.1%	18.5%	18.2%	10.3%
Share employment in natural resources	2.0%	5.6%	3.3%	1.1%	0.6%	1.1%	4.0%

(c) *Analysis of the Socio-Economic Factors and Enforcement Activity*

To determine the extent of any relationship between securities enforcement activity and the above-noted socio-economic factors, we employ multiple regression analysis. Multiple regression analysis allows us to identify and isolate the effect of various factors of influence on enforcement activity. The variable we are attempting to explain in the multiple regression analysis is enforcement activity – here we use the number of investigations per capita.[24] The variables that might "explain" differences across commissions in enforcement levels are the identified socio-economic factors. To the extent that commissions in Canada are similar we might expect any differences in their enforcement activity to fully reflect differences in socio-economic factors. If, instead, we find that commissions facing similar socio-economic conditions differ in their enforcement activity this suggests their enforcement priorities differ for reasons unrelated to socio-economic differences between regions. Our analysis proceeds in two steps. First, we determine if enforcement activity responds to any of the identified differences in provincial characteristics. Second, we determine whether Canadian commissions' current activities introduce greater variation in enforcement activity that is not directly attributable to observable differences in socio-economic factors.

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[24] This is known as the "dependent" variable since it is dependent on the other variables. For example, if we were estimating how income is affected by education and age, income would be the dependent variable, which is explained by education and age – the "explanatory" variables.

We use the U.S. state data for comparison purposes and to assist in determining whether a relationship exists between the identified socio-economic factors and enforcement activity.[25] The U.S. provides a useful comparison in that we expect the SEC to deal with the "national" securities priorities, leaving local enforcement to the states. Thus, the U.S. state data provides a benchmark of how much variation in enforcement activity can be explained by differences in socio-economic factors across regions. Comparing the extent of variation across commissions in Canada to this benchmark allows us to determine the additional variation in enforcement activity that arises under Canada's multiplicity of regulators that is unrelated to regional differences in socio-economic factors.[26] In Canada, commissions must deal with any particular local issues as well as any "national" or common issues that cross jurisdictions.

For the U.S. data to be useful for detecting the idiosyncratic effect of Canadian commissions on enforcement levels, it must be expected to produce less underlying variation in enforcement activity between jurisdictions (states) that is not explained by differences in socio-economic characteristics. As we have seen above, there appears to be greater homogeneity among the U.S. states in respect of their enforcement statistics. Also, as a result of partial centralization, the component of regulatory enforcement that is decentralized in the U.S. is targeted towards those activities that are highly state specific and that require a strong local presence. As one U.S. state regulator noted:

> With the introduction of the National Securities Markets Improvement Act of 1996, Congress decreed that [while] the regulation of the national securities markets was appropriately the role of the SEC, the states should bear the primary responsibility for pursuing securities fraud at the local level. The SEC will probably never have the resources and presence necessary to pursue the local scam artists that prey on ordinary citizens. The states have always been and remain the "local cops on the beat" when it comes to responding to securities frauds targeting the public. The state agencies provide the fastest and only source of assistance for small investors.[27]

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[25] Our Canadian data is complete for ten provinces, though our sample size is larger than 10 since we have data over time for most of the provinces (4 years on average). The U.S. state data is useful in verifying whether we have discovered robust relationships using the Canadian data or whether the estimated relationships are the result of a small sample size.

[26] More precisely, we use regression analysis to examine how enforcement activity is related to various differences in the characteristics of various U.S. states (as well as changes over time in economic conditions). Regression analysis provides a measure of the strength of these relationships as well as their direction. We conduct a similar analysis using the Canadian data. We then compare the relative strength of the relationship between enforcement activity and regional characteristics for the two countries. To the extent that multiple regulators in Canada introduce "noise" in the level of enforcement activity, the strength of the relationships between enforcement activity and provincial characteristics will be reduced.

[27] E-mail from David S. Massey, Deputy Securities Administrator for the Department of the Secretary of State of North Carolina.

Since there is no equivalent of the SEC in Canada, the component of enforcement activity that is *not* highly dependent on provincial characteristics is still in the hands of the individual provincial regulators and each may deal with this common component differently.[28]

We use the number of investigations per capita as a measure of enforcement activity as it provides a reasonable measure of overall enforcement effort.[29] We also have the most consistent data on this measure across jurisdictions and over time. The regional characteristic variables we use are those discussed above.[30]

We begin with a simple specification that relates the number of investigations per capita to per capita disposable income and a time trend. We also include a dummy variable to capture the change made by the BCSC in moving to a risk-based screening system.[31] Below, we present the regression results for Canada and the U.S.

Table 14: Regression Results, Per Capita Investigations as a Function of Income and Time

Variable	Canada	U.S.
Per capita disposable income	0.584	0.645**
BCSC risk-based system	-4.21*	
Time trend	0.135	-0.617*
Intercept	-274	1222*
Observations	39	46
R-squared (R^2)	0.014	0.12

* Significant at the 5% level.
** Significant at the 1% level.

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28 We would expect that even if there were no differences in provinces that would require different approaches or intensities of enforcement, the fact that enforcement is complex would naturally give rise to differences between commissions for reasons that are not closely related to any observable differences in socio-economic factors either between provinces or over time.

29 Nonetheless, some jurisdictions may conduct fewer but more in-depth investigations than others. For example, as mentioned above, BCSC has seen the number of (recorded) investigations drop considerably when it adopted a risk-based approach to regulation. Furthermore, different jurisdictions may have different criteria of what to count as an investigation. However, there is no reason to believe that U.S. state regulators would have a more standardized way of recording investigations than the Canadian commissions.

30 As we have panel data (data that is that is both across jurisdictions and over time) there is also a time-series component to consider. We have time series data (data for a number of years) for disposable income per capita, employment by sector and share of population over various age thresholds. We do not have time-series data on the firm and income distribution variables though we would not expect these would change very much over time. We experimented with including average daily volumes and average daily values of the TSX300 (S&P500 for the U.S. regressions) for each year as a measure of overall market activity.

31 A dummy variable takes a value of 0 or 1. In this case, it is equal to 1 after the BCSC adoption of its risk-based screening system and 0 prior to this.

While the overall fit of both models is low as indicated by the low R-squared,[32] the fit of the U.S. data is better than the Canadian data. More importantly, the U.S. data shows a strong, positive and statistically significant correlation[33] between per capita disposable income and per capita investigations.[34] A positive correlation also exists in the Canadian data, but it is not statistically significant.

Table 15 below provides the results using the fuller set of socio-economic factors as explanatory variables. We excluded some of the right-hand side variables that were not statistically significant from the reported results.[35]

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32 The usual R^2 measures the amount of variation in the dependent variable that is explained by the independent variables. It ranges from 0 to 1 with 0 indicating none of the variation is explained and 1 indicating all the variation is explained. In a random-effects regression there is no R^2 that has the properties of the ordinary least squares R^2. However, the reported R^2 is still useful (and similar to the usual R^2) in describing how much of the variation in the dependent variable (e.g. investigations) is explained by the independent variables. Note, however, R^2s based on two different data sets are not strictly comparable so that small differences in R^2s would not lead us to conclude that one set of data is explained much better than another set of data.

33 A variable is statistically significant if there is a low likelihood that the estimated relationship is due purely to chance because of random sampling.

34 The positive relationship between per capita disposable income and per capita investigations could reflect the fact that richer states are able to spend more on public goods, including enforcement. However, if we include non-enforcement budget per capita in the regressions, which should also be correlated with public funding, the coefficient on disposable income remains positive and statistically significant while the coefficient on non-enforcement budget is insignificant. This suggests that the relationship between income and investigations is identifying the effect of income on investment activity rather than the public funding available for enforcement budgets.

35 We do not include employment shares in manufacturing and natural resources because they were not statistically significant and, moreover, they are collinear with other variables resulting in higher standard errors (i.e. less accurate coefficient estimates). Inclusion of these additional variables does not have a large effect on the coefficient estimates. The percent of population over an age threshold (55, 65, or 75) was not statistically significant in any of the specifications (and had little effect on the coefficient estimates) so we excluded this variable as well.

Table 15: Per Capita Investigations as a Function of Socio-Economic Factors

Variable	Canada	US
Per capita disposable income	0.952	0.98**
Gini coefficient (market cap)	-64	-12.97***
Income > $100,000 (Income > US$75,000)	-198	-48.69**
Percent > age 65 and with incomes >$75,000	6493*	
Percent > age 75 and with incomes > US$100,000		1294
BCSC risk-based system	-4.02*	
Time trend	- 0.12	-0.97**
Intercept	275	1928**
Observations	39	42
R-squared (R^2)	0.77	0.78

* Significant at the 5% level.
** Significant at the 1% level.
*** Significant at the 0.1% level.

Both regressions show considerable improvement in the R^2, indicating that much of the variation in per capita investigations is explained by the socio-economic variables. In addition, in both countries, the regressions are performing similarly in terms of their ability to explain variation in per capita investigations.

The coefficient estimate on per capita disposable income is positive in both regressions though it is only statistically significant in the U.S. regression. Once account is taken of the exchange rate difference, the measured effect of per capita disposable income on per capita investigations between the two countries is somewhat larger in the U.S.

The coefficient on the measure of firm inequality (Gini coefficient) is negative in both regressions and statistically significant in the U.S. regression. Hence, as inequality increases (i.e. more large firms operate in the market) per capita investigations decrease. This may occur because investigations involving larger firms are likely to be more complex and take longer, which reduces the total number of per capita investigations. The much larger coefficient estimate for Canada indicates a greater sensitivity to firm inequality relative to the U.S.

The negative coefficient on high income is consistent with a view that higher income earners have greater knowledge of financial markets and therefore are less likely to be victims of frauds and scams.[36] The positive coefficient on the measures of individuals over age 65 with high-incomes indicates that this group is more likely to fall victim to financial crimes.

[36] Recall that average incomes per capita accounting for greater opportunities for financial crime and rule violations have already be controlled for.

This coefficient is statistically significant in only the Canadian regression (but the coefficient on the somewhat different measure of high-income older individuals for the U.S. is significant at just over the 10% level in the U.S. regression).[37]

We do not find that the lower number of per capita investigations among the larger provinces is due to their use of screening tools other than the obvious reduction in cases that occurred in British Columbia. We included a dummy variable for the larger provinces to capture this potential effect but it was not statistically significant, and is not reported above.

Overall, the coefficient estimates indicate that enforcement responds to regional differences in socio-economic factors in predictable ways in both countries. However, the coefficient estimates tend to be estimated more precisely with the U.S. data (as indicated by the higher degree of statistical significance) which suggests that there is greater uniformity in how these U.S. states respond to differences in socio-economic conditions compared to the responses of Canadian commissions to such differences. On the other hand, the larger coefficient estimates using the Canadian data for the variables that are common in the two country regressions may suggest a greater sensitivity in enforcement response to differences in local socio-economic conditions in Canada.

(d) *Policy Implications of Regional Differences and Enforcement Responses*

The regression results indicate that some (but not all) of the observed differences between Canadian commissions in the level and type of enforcement activities are explained by differences in socio-economic factors. We also find that differences in per capita investigations across Canadian commissions are not as closely correlated with these socio-economic factors as is the case for our sample of U.S. states.

In light of this analysis, it is important that any securities enforcement regime in Canada be designed to be responsive to local conditions. Thus, any centralized system that allocates resources based on an equal budget per capita would not optimally meet the enforcement challenges posed by different socio-economic characteristics in different regions. While our analysis provides some insight into the factors of importance, it is by no means exhaustive.

Responsiveness to local conditions for enforcement need not mean that there is no benefit to be derived in centralizing or harmonizing certain enforcement issues through a changed regulatory structure. As we discuss below, there are costs incurred from having multiple regulators interpret enforcement mandates differently. On its face, there would appear to be little benefit from allowing for possibly different interpretations of the public interest in ensuring the integrity of capital markets across provinces.

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37 We were not able to get the percent of population in Canada of those over 75 with incomes above $100,000. Thus our Canadian and U.S. measures of elderly with high incomes are somewhat different. Ideally, we would have used investment income for those over the age of 75 for both countries, but we did not have this data for the U.S. If we use investment income levels for those aged 50 to 84 in the Canadian regression in place of the percent of population over 65 with incomes above $75,000 we get similar results – i.e. the coefficient is positive and statistically significant.

3. Jurisdictional Overlap

There are two extreme views of Canada's system of multiple securities regulators; one that argues it provides a form of competition among regulators which is beneficial to investors and market participants and one that argues it entails nothing but duplication and administrative waste. In the case of enforcement, the truth lies between these two extremes.

To deal with the first extreme, it is theoretically possible that having multiple commissions pursuing enforcement actions limits the likelihood that one commission will impose rules or sanctions that are costly to financial markets without significant policy benefits. Thus, the Canadian system may offer a form of "regulatory yardstick competition", with the result being improved enforcement. We do not believe the current system provides such benefits. True direct regulatory competition would require that firms could choose their regulator and all other regulators would defer to the chosen regulator. In such an environment, a regulator would have a competitive incentive to develop regulations that reduced regulatory costs imposed on firms to attract firms to choose it as their regulator. This type of regulatory competition does not exist between Canadian securities regulators, nor is it clear that moving in this direction is desirable vis-à-vis investor protection. Furthermore, to the extent that the outcomes of regulatory competition are desirable in financial markets, some of these may be achieved by comparing single regulators across countries.[38]

At the other extreme, the current enforcement regimes of Canada's various commissions do not entail complete duplication and overlap. While in the past, it was not uncommon to have parallel investigations by several commissions into the same or similar conduct this is no longer the case today. The commissions have vastly increased the level of enforcement cooperation and coordination between themselves as well as with SROs. This has resolved many problems of the past, although not all issues have been fully resolved.

Whatever the extent of coordination and cooperation, the very structure of the current regulatory regime in Canada today is likely to result in a sub-optimal level of enforcement from the perspective of a regulator who aims to maximize national interests. There is no mandate for any current commission to act in the national interest, though the SROs may have this broader mandate in respect of their members. Each commission rightfully operates in its own provincial interest. While some might subsume such interests or take into account the possible effects their actions may have outside of their own jurisdiction there is no reason to believe that this will happen as consistently or effectively as would exist with a national regulator. Quite simply, there is no mechanism to deal with conflicting interests when these arise or to force a commission to fully account for the externalities – positive or negative – that its enforcement decisions create for other jurisdictions.

While some violations of securities laws and regulations entail localized issues only, most registrants and issuers in Canada have national presences. Thus, investigations into suspected wrongdoing inevitably raises issues in multiple jurisdictions. As a result, enforcement

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[38] In keeping with this objective, when benchmarking best practices in enforcement, the BCSC and OSC focused on the SEC and FSA.

by one regulator provides benefits to constituents in other jurisdictions (and, accordingly, regulators of other jurisdictions). But the regulator engaged in the enforcement incurs all the cost from such effort, without necessarily accruing all of the benefits. This may result in fewer resources dedicated to enforcement than would be optimal from the perspective of the national interest.[39] Alternatively, there may be pressure to be seen to be "doing something" in the face of particular high-profile cases, such that several jurisdictions wish to play a role. Where enforcement is then carved into components that allow several commissions to play a role, this may result in higher enforcement costs to regulators and private parties. It may also mean more resources are dedicated to enforcement than is optimal from the standpoint of a national regulator.[40] Finally, there may be conflicting interests between jurisdictions if, for example, most of the affected investors reside in one jurisdiction, but a powerful corporate interest resides in another jurisdiction. The commission with the resident corporate interest and no affected investors is unlikely to find the public interest of its province is affected similarly to that of the jurisdiction with the affected investors. The identity of the jurisdiction leading the enforcement action may determine the outcome – again this may be more or less enforcement than would be optimal from a national interest perspective.

Thus, well coordinating commissions under the current structure may produce an outcome that differs very little from that which a national regulator would achieve. To determine if this is the case, in this section we examine the data available on overlap and cooperation among commissions and SROs. We also consider the qualitative evidence offered by market participants – both directors of enforcement at commissions and securities litigators who deal with the commissions and SROs – on the extent to which there is duplication or added cost related to the multiplicity of regulators.

(a) *Data Available on Referrals, and Concurrent and Joint Investigations*

There are few instances of reported parallel or concurrent formal proceedings by several commissions. The BCSC reports that the number of concurrent investigations by commissions is less than 5% of total enforcement cases (no data is provided in support of this statement). The Saskatchewan Securities Commission reports only 1% of investigations are concurrent with another regulator.[41] The number of concurrent investigations between RS and a commission is slightly higher than 1% for investigations handled by RS' Toronto office, but lower for RS' Vancouver office. Table 16 below shows the percent of RS investigations that were concurrent with various commissions and the IDA. Almost 7% of its Toronto office investigations were concurrent with the OSC. RS claims that that there was significant cooperation between regulators when conducting these investigations. Investigative work is normally divided up among regulators. RS is typically the lead investigator when the case involves RS subject matter. For example, RS would take the lead in a market manipulation case while the IDA would take the lead in a conduct of accounts case.

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39 This is an example of a potential *positive* externality that leads to regulatory failure (i.e. regulation that fails to achieve a first-best level).

40 This is an example of a potential *negative* externality that leads to regulatory failure.

41 However, PEI reported that it has had numerous investigations with multiple regulators, though does not refer to these as concurrent.

Table 16: Concurrent RS Investigations as a Percentage of Total RS Investigations Opened (1998-2002 Average)

Concurrent with	RS Toronto	RS Vancouver
OSC	6.8%	0.0%
ASC	0.7%	0.0%
BCSC	0%	0.2%
NSSC	0.7%	0.0%
CVMQ	0%	0.0%
IDA	2.0%	0.0%

Flowing from the limited instances of parallel independent proceedings, generally commissions reported no cases of jurisdictional conflict. Similarly, RS did not have any examples of jurisdictional conflict with the IDA or commissions. PEI provided the one example we have of jurisdictional conflict, which involved a conflict with the Nova Scotia Securities Commission.[42]

The lack of jurisdictional conflict is the result of considerable coordination and communication efforts undertaken by the commissions and SROs. For example, the BCSC reports that it meets monthly with representatives from the IDA, the TSX Venture Exchange, and RS. It also meets quarterly with representatives from the Vancouver Police Department, the RCMP, and Industry Canada. In addition, monthly conference calls and twice-yearly meetings are held with the enforcement divisions of the securities commissions in Canada to discuss matters of interest. Similarly, RS engages in considerable communication with commissions and the IDA. In the case of the IDA, the information exchange is extensive as the enforcement arms of RS and the IDA share information about investigations by inputting details into the IRIS database. With the commissions, RS provides a monthly report to its recognizing commissions (i.e. ASC, BCSC, MSC, OSC, CVMQ) describing all investigations and prosecutions that have been opened and closed. Further to the communications between RS and the commissions, two organizations were created to share information, the Securities and Enforcement Review Committee in Ontario and the Joint Securities Enforcement Review Committee in Alberta. These organizations serve the purpose of determining when a joint investigation into a matter would be warranted. Members hold meetings every two months to discuss those cases where joint investigations would be appropriate. RS recommends this type of organization should be in place in all major securities markets in Canada with relevant information shared nationally. Quite apart from these formal settings, information is also shared on a case-by-case basis, as requests or referrals are made between commissions and SROs.

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42 From the PEI Securities Office's perspective, the Nova Scotia Securities Commission failed to take enforcement action on a perpetrator who was based in Nova Scotia but operated in both provinces after efforts were made to obtain meaningful cooperation. The PEI Securities Office moved forward on its own and ultimately prevailed in its prosecution with imprisonment part of the remedy.

As noted earlier, it is inevitable that certain securities investigations, particularly the larger or higher-profile investigations, will touch upon several commissions' jurisdictions. In such cases, the regulators may defer or refer the matter to another regulator,[43] or alternatively they may compartmentalize the investigation into components that are addressed by different regulators. When dividing a higher-profile case between regulators, it is typical for a lead regulator to cover the majority of issues. The regulators determine amongst themselves who will act as the lead. Lead regulators are presumably chosen on the basis of some combination of jurisdiction, where the effects are greatest, internal expertise and likelihood of success. Joint investigation will be pursued when specialized skills of both regulators are required.

We present the data we have from commissions on their investigation referrals in Table 17 below. The number of referrals by any of the commissions is not insignificant (for instance, the Nova Scotia Securities Commission only had 81 investigations in 2002). While no precise counts were provided, the Saskatchewan Securities Commission reported that about 25% of its investigations are referred to an SRO. While most of the Nova Scotia Securities Commission files were referred to the IDA, the OSC referred only one file to the IDA in 2002. Most of the OSC referrals were to other commissions.

Table 17: Referral Activity by Commissions in Fiscal Year 2002

	From		
To	OSC	NSSC	BCSC
Another Commission	21	0	—
IDA	1	22	—
MFDA	0	4	—
RS	0	20	—
Other	9	0	—
Total Referrals	31	28	66

RS also refers a significant number of files to commissions and the IDA. Table 18 below shows the number of RS referrals by office. In particular, referrals by the RS Toronto office to the IDA and OSC are often a large fraction of the total files opened. There also is considerable variation in the number of referrals from year to year.

43 When referring matters to SROs, the commissions may reserve the right to take action in the event that the SRO's ruling is believed to be insufficient or against the best interests of the public. This is the stated policy of the Nova Scotia Securities Commission for example.

Table 18: Cases Forwarded By RS

	RS Vancouver		RS Toronto	
Year	Files Opened	Forwarded to ASC/BCSC/IDA	Files Opened	Forwarded to OSC/IDA
1998	131	16	42	23
1999	128	3	31	18
2000	86	14	22	12
2001	81	19	24	4
2002	26	15	27	3

(b) *Security Litigators' Perspective*

There is universal agreement among the securities litigators to whom we spoke[44] that the commissions have made great strides in cooperating more fully than was past practice. As noted above, there are no longer parallel proceedings launched by commissions in respect of the same conduct. Such conduct did little to improve enforcement, only provoking ill will between the commissions as they competed amongst each other. Respondents in such cases found it very difficult to coordinate the various actions, adding to the time and expense of resolving the multiple commissions' concerns.

The solution, as described above, has been a combination of either joint investigations, appointment of a lead regulator, or partitioning of the investigation into non-overlapping components. While all of these options are better than parallel, independent proceedings, each generates its own problems from the perspective of counsel.

Joint investigations (and joint hearings) are employed when there are significant interests of several commissions and no obvious lead regulator. Joint hearings can entail scheduling and other logistics problems that increase the time taken for the investigation and hearing. Beyond the difficulties of scheduling, there may be differing procedures before different commissions. Agreement must be established as to the procedures and processes to be followed. Often these are done on a case-by-case basis. Added time inevitably adds complexity and cost to the proceeding that could be avoided if there was only one regulator.

Appointment of a lead regulator avoids the logistical problems of joint hearings. However, appointment of a lead regulator does not necessarily mean there is only one regulator involved or relevant. Below we describe two situations where appointment of a lead regulator is not equivalent to dealing with a single regulator.

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44 We interviewed senior securities counsel at the following firms: Blake Cassels & Graydon, Borden Ladner Gervais, Fasken Martineau, Groia & Company, McCarthy Tetrault, Ogilvy Renault, Torys, and Weir & Foulds.

First, the lead regulator may be meeting with other regulators as its investigation proceeds. In situations involving settlement discussions, counsel described cases they had been involved with where the lead regulator was regularly consulting other commissions as to the terms of the settlement under discussion. When other commissions had comments or changes they wanted, these were brought to the attention of counsel by the lead regulator. In this fashion, the settlement terms were revisited several times. The process took much longer (and hence was more costly to, and involved greater uncertainty for, the client) than would have been the case if there had been only one regulator with whom settlement discussions were being conducted.

Second, in cases where there are not ongoing discussions with other regulators during the settlement, the respondent may have little assurance that other commissions will accept the settlement negotiated with the lead regulator. If the other potentially interested commissions do not involve themselves in the lead regulator's settlement discussions, the respondent may find that additional settlement terms may be sought later by another commission. In light of this possibility (which is not regarded by counsel as remote), counsel advising clients alter their strategy and conduct in anticipation of having multiple regulators involved. Thus, even if multiple regulators are not ultimately involved, the possibility of such action has affected the process in a manner that adds time and cost for clients relative to a world where only one regulator is dealt with.

A final point in respect of lead regulators: some counsel noted situations where they are acting for a party who is attempting to initiate enforcement action. Several regulators may be approached given the potential for each to have an interest in the investigation. Where the case is not a flagrant violation, or it is more complicated or difficult, regulators may be reluctant to take the lead. Counsel can expend considerable time and effort meeting and discussing the case with several regulators, at added cost to the client. Such costs would be avoided under a system of a single regulator.

Finally, cases may be partitioned into components that involve several regulators, including commissions and SROs. Several cases are useful as an illustration of this practice. In the case of Cartaway,[45] investigations were launched by the TSE, VSE, ASE, BCSC and ASC. The OSC did not launch its own investigation but oversaw the TSE. Settlements were eventually reached with the TSE that covered the main issues under investigation. The settlement with the ASC also dealt with the issues raised by the Alberta Exchange, but dealt only with trade tickets. Settlement with the BCSC included settling the Vancouver exchange investigation. From counsel's perspective the trade ticket issues could have been subsumed into the TSE investigation and settlement. As well, the settlement with the BCSC was regarded as largely similar to that negotiated with the TSE, raising questions as to why it needed to be pursued separately.

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[45] British Columbia Securities Commission COR#01/064 in the Matter of the Securities Act R.S.B.C. 1996, c. 418 and in the Matter of Cartaway Resources Corporation and in the Matter of Robert Arthur Hartvikson and Blayne Barry Johnson, Decision, June 7, 2001.

In the Yorkton case,[46] investigations were launched by the TSE, OSC, Canadian Venture Exchange and BCSC. Settlement was reached with the TSE and Venture Exchange jointly. As after the TSE settlement. Ultimately, the BCSC allowed the OSC to lead, and did not require an additional settlement.

In both cases, the settlements involved financial penalties and payment of the various regulators' costs. This is not unusual. We would expect that while great effort may be taken to avoid duplication between the regulators, there is likely to be some time and effort spent by each regulator on background issues that are common across the various investigations. To the extent that the costs for these exercises are recovered from the parties, the respondent has paid for these efforts multiple times. As well, the respondent's counsel may have attended multiple meetings with various regulators covering similar or related issues. The respondent will then be paying legal fees and disbursements multiple times. A single regulator would avoid these costs.

Our discussions with counsel also raised questions as to the effectiveness of remedies under the current system. For example, in the insider trading case launched against former British Columbia premier Bill Bennett, the case evolved in the following manner. Bennett was acquitted of insider trading by the British Columbia courts. Subsequent proceedings launched by the BCSC resulted in Bennett having his trading rights revoked in British Columbia. As the OSC never launched any action against Bennett, the revocation of his trading rights in British Columbia does not constrain his trading in Ontario where the exchanges are located. In such a case, one might argue that the BCSC remedy is ineffectual because it is not national. Alternatively, if the OSC is correct and there was no reason to revoke Bennett's trading rights, the BCSC hearing should never have been launched following the acquittal decision. Under either scenario, the multiplicity of regulators resulted in sub-optimal enforcement relative to a single regulator.

Securities counsel also discussed the potential overlap between a single commission and SROs. Most of the counsel to whom we spoke had cases involving the OSC and one or both of the IDA and RS. In cases involving the OSC and RS, counsel felt there was little overlap and little unwieldiness in the process caused by dealing with the different enforcement silos. RS' independence was noted as a good model generally.

The model most frequently cited by securities litigators to resolve the problems noted above is one of a national regulator with branch offices. Multiple branch offices would incorporate regional interests and allow for local enforcement. Such a model would remove the costs currently incurred by regulators and respondents related to logistical complications from

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[46] In the Matter of the Securities Act R.S.O. 1990, c. S.5, as Amended and in the Matter of Yorkton Securities Inc., Settlement Agreement, December 19, 2001. See also In the Matter of the Securities Act R.S.B.C. 1996, c. 418 and in the Matter of Canadian Venture Exchange Inc. and in the Matter of Yorkton Securities Inc., Decision, March 6, 2001.

joint investigations and hearings, and from the duplication arising in partitioning investigations into components. It would also resolve the problems noted above when the lead regulator is not the only regulator involved in reality or perception. This model is believed to be one that engenders greater flexibility, effectiveness, and timeliness. As well, it is more economical for regulators, intermediaries and issuers compared to the current system of multiplicity. In the next section, we estimate the cost savings available from a move to this model.

4. Economies of Scale in Enforcement

As markets get larger, we expect there to be a need for increased enforcement activity as discussed earlier. If the need for additional enforcement resources is less than a 1:1 relationship with increases in the market size, economies of scale in enforcement exist.[47] We might expect the main source of such economies of scale, should they exist, to be spreading fixed costs over a larger number of investigations. Thus, a potential benefit that may be had from more centralized enforcement is savings from exploiting economies of scale in enforcement. In other research, we have found substantial potential savings available to Canada should it move to a single national regulator with multiple branch offices. In 2002, the savings would have been at least 30% of the combined 2002 operating budgets of the 13 commissions.[48]

We expect to find economies of scale in securities regulation extend to enforcement; that is, the fixed costs of enforcement can be spread over a larger number of investigations under a more centralized model.[49] Furthermore, the regulator may be better placed to add specialized staff (and have such specialized staff be more effective by improving their critical mass) compared to the individual commissions today.

At the same time, the extent of economies of scale may be tempered by the nature of enforcement activity. Enforcement involves investigators and litigators pursuing individual cases. It is unlikely that these investigators and litigators would individually be able to process more cases as the jurisdiction becomes larger. In other words, fixed costs, while present, may be a relatively small share of total enforcement costs compared with other aspects of regulation such as policy-making.

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[47] Economies of scale in regulation are the reductions in per unit costs that come about as the market under regulation becomes larger.

[48] CRA, "Estimating the Incremental Costs of Multiple Securities Regulators in Canada," (2003), a report prepared for the Investment Dealers Association of Canada.

[49] For example, both the OSC and BCSC jointly commissioned a study by AssetRisk on best practices in enforcement. The Market Integrity Computer Analysis System (MICA) has been jointly developed by the commissions to enhance their ability to detect suspect trading practices.

To calculate economies of scale we build on our earlier work for the IDA.[50] In particular, we estimate the relationship between the costs of enforcement and market size. We collected data on the enforcement budgets of regulators as a measure of enforcement costs and GDP for the corresponding jurisdictions as a measure of market size.[51] [52] We then measure the rate at which enforcement budgets increase with increases in market size. The relationship between increases in market size and increases in enforcement budgets allows us to determine the required enforcement budget for a revised regulator structure and hence the potential savings relative to the status quo.

We extend our analysis to non-enforcement activities as well. Since we have data on total budgets for states and provinces, we know the total regulatory budget spent on non-enforcement activities. We calculate cost savings of centralization for both enforcement and non-enforcement activities. The sum of the imputed savings is the total potential savings from centralization. In our analysis for the IDA, we computed this *total* savings directly. As we discuss below, the two different estimates are very similar.

In addition to the Canadian data, we collected data on enforcement budgets of some U.S. states and the SEC. This additional data is valuable in expanding the sample size, which allows for more accurate estimation. A small sample size results in less accurate estimates. As well, there are important differences between large and small regulators in Canada, which would further reduce the accuracy of any estimation performed using Canadian data only. Of course there are also differences between the enforcement roles of Canadian provincial regulators and their U.S. state counterparts. In the United States, the SEC is the primary overseer and regulator of the U.S. securities markets, while the state regulators focus mostly on those who sell securities within their jurisdiction. In Canada, any one provincial regulator may assume both roles. As a result, estimated economies of scale for U.S. states may differ from those in Canada. However, as indicated above (see Figure 6) smaller Canadian commissions and U.S. state regulators are more comparable in the context of regulatory budget relative to GDP compared to the differences that exist between larger and smaller commissions in Canada.

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50 *Supra* note 48.

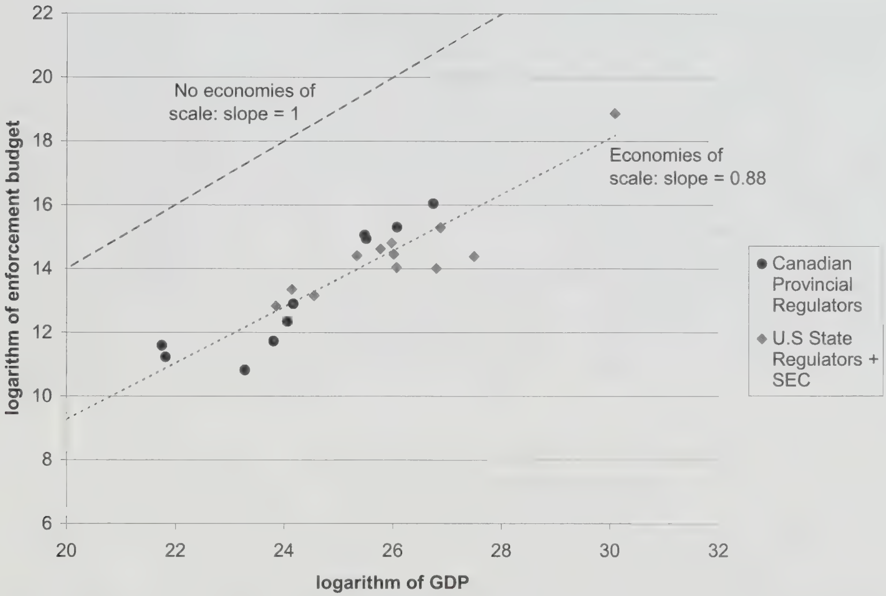
51 The enforcement budgets for some commissions were unavailable so we used the ratio of employees in enforcement relative to total employees to determine the share of total budget allocated to enforcement. For jurisdictions where we had both employees and budget information for enforcement and non-enforcement activities, the ratio of enforcement employees to total employees is generally very similar to the ratio of enforcement budget over total budget, as noted above in Table 3.

52 We chose GDP as a measure of market size rather than population because it better explained the variation in enforcement activity. Alternative measures of market size are discussed in the section on sensitivity tests.

(a) *Graphical Analysis*

Below Figure 12 plots budget size against GDP (in logarithms).[53] We distinguish the data that are related to Canada and those which are related to the U.S. An upward trend (the line running through the data) is evident from the data, indicating that operating budgets increase with GDP as we expect. The relationship between regulatory budgets and GDP is less than one-to-one for the data combined. That is, visual inspection of the data suggests that increasing GDP by 1% does not lead to a 1% increase in operating budgets, indicating that economies of scale exist.

Figure 12: 2002 Enforcement Budgets and GDP by Jurisdiction



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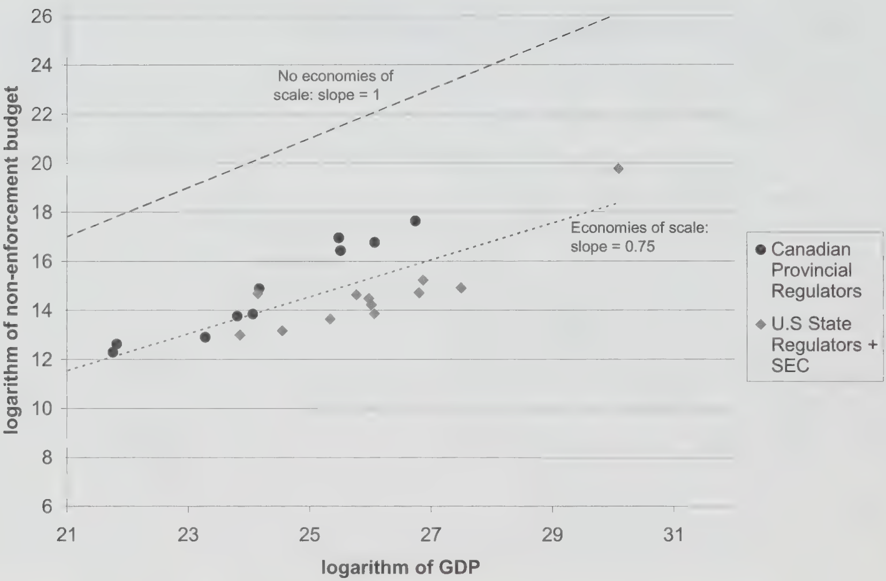
[53] The natural logarithm is a mathematical transformation that is commonly used to estimate economies of scale. A straight line through data in logarithms implies that the percentage change in cost for a small percentage change in market size is constant regardless of how large the market is. It is a good first-order approximation. Our ability to estimate a specification that is more flexible is limited by the small sample of data.

Figure 13 below shows a similar plot of non-enforcement budget against GDP. Relative to Figure 12, the larger regulators lie considerably above the trend line. This likely reflects the fact that the existence of the SEC reduces the regulatory capacity required of state regulators, and smaller provincial and territorial regulators in Canada are able to defer some regulatory policy issues to the larger Canadian commissions.[54]

Figure 13: 2002 Non-enforcement Budgets and GDP by Jurisdiction



The second important difference between the figures is that the trend line in Figure 12 is steeper than that trend line in Figure 13. The implication of this is that economies of scale are less in enforcement than in other areas of regulation, likely for the reasons mentioned above. We examine these differences more carefully using regression analysis.

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54 Our previous research for the IDA provides evidence for this explanation. We showed that when other countries were included in the analysis, the trend line for overall economies of scale for the larger provinces was much closer to that for other countries than for the territories, smaller provinces and states.

(b) *Regression Estimates of Economies of Scale*

Since labour costs are a large component of total enforcement costs, differences in salaries between regions due to differences in costs of living may affect total labour costs. The graphical analysis does not control for differences between jurisdictions in cost of living. We hold constant this effect by using regression analysis.[55] The regression essentially separates the effects of cost of living and market size in explaining the size of the budget. Separate regressions are done for enforcement and non-enforcement budgets. We take the natural logarithm of the variables as we did in the graphs so that the relationships are all measured as percent changes over percent changes. Thus, the estimated coefficient from the regression on, for example, GDP, provides an estimate of the percentage change in enforcement budget associated with a percentage change in GDP.

To account for the additional costs imposed on the primary jurisdictions we add a term that allows the regression line to shift, referred to as a dummy variable. This allows for the possibility that even after controlling for market size and the cost of living, primary regulators may have higher costs. This is somewhat different from the model specification we used in our earlier analysis for the IDA. There we accounted for the higher costs for the primary Canadian jurisdictions (and country regulators) by allowing the slope of the regression line to differ between large and small regulators. Below we discuss how the different specifications affect the results. The details of our regression analysis are reported in Appendix 1.

Our results indicate that for every 1% increase in GDP, the enforcement budget would increase by 0.57% and the non-enforcement budget would increase by 0.44%.[56] Thus, for example, if the regulators of the Atlantic provinces were combined into a single regulator (equivalent to tripling the size of New Brunswick) they would save 29% in enforcement costs and 58% in non-enforcement costs.

(c) *Estimates of Potential Cost Savings from Consolidation*

We use the regression results to estimate potential savings from consolidation. We construct a benchmark for reorganization by assuming that there is a single regulator with its head office in Ontario and five branch offices. The branch offices are assumed to be in Alberta (responsible for the territories), British Columbia, Manitoba (responsible for both Manitoba and Saskatchewan), Nova Scotia (responsible for all of Atlantic Canada) and Quebec.

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55 We include a measure of the cost of living in the regression analysis so that we measure the relationship between cost and market size that would exist if the cost of living were the same in all regions. We take into account the regional variation in the cost of living in determining the costs of branch offices and the central office.

56 These estimates are lower than the ones we obtained for overall economies of scale for the IDA study. We use a slightly different specification here by including a dummy variable for the large provinces rather than including a separate slope variable (i.e. interaction of the large Canadian regulator dummy with log GDP) for larger provinces. The former fits the data better when the data are broken down into enforcement and non-enforcement components. The overall effect is to generate a somewhat larger estimate of the economies of scale savings.

Below, Table 19 provides the current estimates of enforcement budgets for Canadian commissions, the estimated enforcement budgets under the new regime using the economies of scale estimate discussed above, and the difference in these figures, which is the cost savings. The estimated enforcement budgets under the new regime are derived using the economies of scale estimates. The economies of scale estimate provides the enforcement budget required for any given jurisdiction's GDP.

Table 19: Estimated Annual Cost Savings in Enforcement from Consolidating Regulators ($ millions)

	Actual	New Regime	Savings
All of Canada	21.3		1.8
Ontario Head Office		15.3	
Alberta Branch		0.6	
British Columbia Branch		1.2	
Manitoba Branch		0.4	
Nova Scotia Branch		0.3	
Quebec Branch		1.6	

The branch office budgets are based upon the estimated fixed difference in costs between the larger and smaller jurisdictions (see the Appendix).[57] The $1.8 million annual savings is 8.6% of the 2002 enforcement operating budgets for all Canadian provincial and territorial securities commissions.

Table 20 below provides the cost savings in all other areas of regulation from a model of a central regulator with branch offices.

[57] Our estimate of the allocation of resources between the central office and branch offices is derived from the implied differences between the larger and smaller commissions. Of course, in any actual implementation of the central regulator model the allocation may be different. In particular, the more resources that are allocated to branch offices away from the central office the lower the economies of scale benefit.

Table 20: Estimated Annual Cost Savings in Non-enforcement from Consolidating Regulators ($ millions)

	Actual	New Regime	Savings
All of Canada	106.5		44.8
Ontario Head Office		54.9	
Alberta Branch		1.4	
British Columbia Branch		1.6	
Manitoba Branch		1.0	
Nova Scotia Branch		0.9	
Quebec Branch		2.0	

The $44.8 million annual savings represents 42.1% of the 2002 non-enforcement operating budgets for all Canadian provincial and territorial securities commissions. The combined savings are $46.7 million or 36.5% of the total 2002 operating budgets.

Our IDA estimates of savings were about 30%.[58] The difference is partially due to separating the data into enforcement and non-enforcement components and partially due to a different specification and different data. For example, if we apply the larger sample of states that we have here to our earlier analysis for the IDA, we obtain savings of $48 million, which is 37.5% of current cost levels. It is not surprising with statistical analysis to see this amount of variation in the estimates. We conduct some additional sensitivity tests below.

A consolidated regulator would have a greater share of expenditures on enforcement because economies of scale are lower in enforcement than in non-enforcement. Currently about 17% of the operating budget is directed toward enforcement. For the head office of a national regulator this would increase to 22% and for the branch offices the shares would range from 25% to 45%.

(d) *Policy Implications of Smaller Economies of Scale in Enforcement*

The fact that we find the percentage savings in enforcement expenditures on the order of a quarter of those in non-enforcement expenditures is important for policy. It suggests that one main argument for centralizing regulation – savings from greater efficiencies – is less important for enforcement. As such, a model that is able to retain the efficiency benefits from centralizing other regulatory activities but maintains decentralized enforcement is desirable.

[58] If total savings were closer to 30%, but the ratio of enforcement to non-enforcement savings remained the same, the savings in enforcement would be $1.9 million (9%) and in non-enforcement would be $37.8 million (36%).

(e) *Sensitivity Tests*

While we have provided our best estimates of potential savings above it is useful to test the robustness of these estimates. There are several sources of possible uncertainty. First, the form of the specification may affect the results. For instance, in our IDA analysis we allowed for a separate relationship between market size and budgets for the large Canadian jurisdictions and countries. Second, sampling variation can lead to different results so that the same specification will yield different results when applied to a different data set. Third, assumptions about the variable used to measure market size may affect results.[59] Fourth, the number of branch offices will change the cost savings estimate.

Table 21 below provides the estimated cost savings for several cases. For each case we provide an upper and lower bound estimate of the cost savings. This bound represents the 95% confidence interval. That is, we can be 95% confident that the true cost savings lie within the confidence interval.[60] There is a considerable range of estimates for each case, which simply reflects the level of accuracy available in the data.

Case 1 shows the original IDA savings estimate (no confidence interval was computed for that analysis). Expanding the original IDA sample with additional data for other states increases the point estimate to nearly the same level we obtained with the enforcement data set. Excluding states with imputed budgets (case 2) has little effect on the estimated savings though the confidence interval increases.[61] Case 3 adds an additional indicator (or dummy) variable for the large jurisdictions.[62] The estimated cost savings fall somewhat to $42.1 million. In the IDA analysis we also controlled for two outliers (Sweden and New Zealand). The savings increase considerably if we do not control for these countries. Finally, if we drop the Manitoba office, there is a small increase in cost savings from $48.2 million to $49.4 million.

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59 Ideally we would like to measure market size by reference to market capitalization; however, data on market capitalization do not exist at the province or state level. We have considered an alternative measure of market size based on population, but find that GDP provides a better measure of variation in budget compared to population – it "fits" the data better than population. Nevertheless, if we use population rather than GDP as a measure of market size the estimated savings are similar.

60 Because of sampling variation the estimates will never be precisely exact. If we had many different samples, the estimated savings from these would most of the time (95% of the time) lie within the interval. Note that the best estimate does not lie quite in the middle of the range due to the effect of converting logarithms back to levels.

61 For those familiar with statistical analysis, we note that we did not take into account the fact that the imputed variables are estimates when calculating our standard errors. Thus, the confidence intervals (except for case 3) are somewhat understated.

62 In more technical terms, the original IDA analysis included a different slope but not a different intercept term for the large jurisdictions.

Table 21: Sensitivity Tests of Economies of Scale Cost Savings

	Case	Cost Savings	Upper Bound	Lower Bound
1	Original IDA	$40.1 million		
2	New Base with Additional States and Imputed Budgets	$48.2 million	$65.0 million	$26.9 million
3	Exclude States with Imputed Budgets	$43.1 million	$64.2 million	$14.8 million
4	Additional Dummy Variable for Large Jurisdictions	$30.0 million	$48.1 million	$6.9 million
5	No Control for Outliers*	$35.6 million	$51.1 million	$15.4 million
6	No Manitoba Office	$49.4 million	$66.1 million	$28.2 million

* New Zealand and Sweden were considered as outliers in the original IDA analysis

Taken together, the sensitivity results indicate that the overall conclusion of substantial cost savings is robust. Nevertheless, there is uncertainty in the precise amount of cost savings.

Appendix

Regression Estimates of Economies of Scale

We employ regression techniques in order to control for cost of living effects in the estimation of economies of scale in securities commission enforcement. We use a log-linear regression specification with the log of enforcement budget and log of non-enforcement budget as dependent variables.[63] In this way, the coefficient estimates of the variables of interest may be interpreted as elasticities. In essence, we are estimating the percentage increase in enforcement costs for one percent increase in the market size. In this case, an elasticity of less than one indicates that for a doubling of the size of the market under regulation, the cost of enforcement would increase by less than double; i.e. there are economies of scale.

Table A1 below reports the regression results. The adjusted R^2 of 0.93 indicates that much of the variation in enforcement budgets is explained by the regression model. The cost of living coefficient is positive, as expected, but is not measured very accurately as indicated by the large confidence interval. (The 95% confidence interval essentially means that there is a 95% likelihood that the true value lies within the interval, assuming the model is correctly specified.) The coefficient on GDP is less than one, indicating economies of scale. The estimate is quite precise and even at the upper bound of the 95% confidence interval the elasticity estimate is below 1.

Table A1: Regression Results
(Logarithm of Security Regulators' Enforcement Budgets)

Coefficient	Estimate	Standard Error	95% Confidence Interval	
GDP (in logs)	0.57	0.09	0.39	0.76
Large Securities Regulator Dummy	1.17	0.28	0.57	1.76
Cost of Living (in logs)	2.4	0.81	0.72	4.12
Constant	-28.1	7.74	-44.4	-11.8
Adjusted R^2	0.93			
Observations	22			

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63 Log(Securities Regulators' Enforcement Budgets) = $\alpha + \beta_1 \times$Log(GDP) + $\beta_2\times$Large Security Regulator + $\beta_3\times$Log(Cost of Living) + μ

Log(Securities Regulators' Non-Enforcement Budgets) = $\alpha + \beta_1\times$ Log(GDP) + $\beta_2\times$ Large Security Regulator + $\beta_3\times$Log(Cost of Living) + μ

Table A2 below reports the results of the regression with securities regulators' non-enforcement budgets as the dependent variable. The overall fit of the equation continues to be good, as in the earlier regression, with the adjusted R^2 equal to 0.91 and the GDP and Large Security Regulator Dummy coefficients are both statistically significant (i.e. the 95% confidence interval does not include zero).[64]

Table A2: Regression Results
(Logarithm of Security Regulators Non-Enforcement Budgets)

Coefficient	Estimate	Standard Error	95% Confidence Interval	
GDP (in logs)	0.44	0.099	0.23	0.64
Large Securities Regulator Dummy	2.59	0.32	1.93	3.25
Cost of Living (in logs)	0.64	0.90	-1.26	2.54
Constant	-4.1	8.7	-22.3	14.1
Adjusted R^2	0.91			
Observations	22			

These regression estimates allow us to infer what the cost savings in enforcement and non-enforcement would be if Canada moved to a system of one single regulator with branch offices in Alberta, British Columbia, Nova Scotia, Quebec and a head office located in Ontario. We impute cost savings by determining what the securities regulators' predicted cost would be if they were consolidated into one national regulator with branch offices in the above-mentioned locations.

64 Recall that the 95% confidence interval indicates the range of values within which we are 95% confident the true value of the estimated variable lies. Should the 95% confidence interval include the value of zero, then we cannot reject the "null hypothesis" that changes in, for example, the cost of living has no effect on the costs of enforcement.

The Costs of Compliance in Canada's Securities Regulatory Regime

Research Study Prepared for the
Wise Persons' Committee

Anita Anand
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October 28, 2003

The Costs of Compliance in Canada's Securities Regulatory Regime

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Anita Anand is an Associate Professor at the Faculty of Law, Queen's University. She obtained a B.A. (Hons) at Queen's University, B.A. (Hons) in Jurisprudence at Oxford University, an LL.B from Dalhousie University, and an LL.M from the University of Toronto. Professor Anand researches and teaches in the areas of corporate law and securities regulation. She recently won the Canadian Association of Law Teachers' Scholarly Paper Award for her research and writing on direct public offerings. She has received research grants from the Social Sciences Research and Humanities Research Council of Canada, the Foundation for Legal Research and the Queen's Advisory Research Council. She is the Director of the Torys Business Law Workshop and the Faculty Coordinator for the Queen's Annual Business Law Symposium.

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Peter Klein is an Associate Professor of Finance in the Faculty of Business Administration at Simon Fraser University, the Academic Director for the Global Asset and Wealth Management MBA Program and a former trustee of the SFU Academic Pension Plan. He is a Chartered Financial Analyst, a Certified Business Valuator and is the Director of Professional Development for the Vancouver Society of Financial Analysts. He spent approximately 10 years in a variety of roles at CIBC/Wood Gundy Financial Products including two-year postings in both Tokyo and London, U.K. He holds a Ph.D. in Finance from the University of Toronto, an M.B.A. and LL.B. from the University of Western Ontario and also studied at the London Business School and université Laval. He has research interests in asset pricing, taxation, derivative securities and corporate governance and has published in a number of leading academic journals.

The Costs of Compliance in Canada's Securities Regulatory Regime

Executive Summary

Mandate

We have been retained to analyze the differential costs associated with the current securities regulatory structure relative to alternative structures. We have been asked to adopt a case study approach to examine a mutually agreed number of transactions, analyzing the direct and indirect costs for affected market participants (issuers and intermediaries), and how those costs might differ under alternative regulatory structures. We have also been asked to review previous cost studies as well as submissions to the Wise Persons' Committee (WPC) and to rely on the data in those documents where appropriate.

Methodology and Findings

We examined four areas of securities regulation in order to analyze the related costs inherent in the current regime. We selected three case studies in each of four categories: (i) firms that require registration; (ii) issuers that have completed an IPO; (iii) issuers that have raised capital in the exempt market; and (iv) issuers that have launched a takeover bid for a Canadian target.

We focused on the material incremental costs incurred under the current system. Materiality is a financial concept and represents a cut-off point below which amounts are insignificant in their context. Where amounts are immaterial, we further considered the extent to which they would need to increase in order to breach materiality thresholds. Where we identified material incremental costs, we considered whether these would be reduced or eliminated under the proposed passport system of regulation, uniform securities legislation, or a single national securities regulator.

Our results are based on interviews with, and written responses received from, market participants who agreed to take part in this study on a confidential basis. Our findings are as follows:

General

1. Registrants are more likely to incur material incremental costs than issuers who, by and large, do not incur such costs as a result of the existence of multiple securities regulators in Canada.

2. Case study participants uniformly reported significant incremental opportunity cost risk. Opportunity cost risk frequently arises due to delays in transactions or the commencement of trading. Delays in executing transactions entail significant risk to issuers.

3. We found that neither issuers nor registrants are over-staffed to a significant degree due to the existence of a multiplicity of securities regulators. While we could not determine whether external advisors are over-staffed, the cumulative effect of advising multiple clients may in fact result in over-staffing.

4. Case study participants conveyed to us a deep level of frustration with the current regime. The feedback we received indicated that market participants strongly believe that the duplication and lack of harmonization inherent in the current regulatory regime are onerous and do not strike an appropriate balance between stakeholder protection and commercial needs. Market participants further represented that the high level of regulatory uncertainty regarding the securities regulatory regime detracts from their ability to manage their businesses. While this feedback is important, it is not related to incremental costs *per se* and is therefore not analyzed in the body of this report.

5. Overall, any of the three alternative regulatory models will reduce or eliminate material incremental costs and opportunity cost risk. To varying degrees, there is uncertainty about the precise operation of each alternative regulatory model under the four areas of securities regulation that we examined. Therefore, on the basis of our cost analysis, we cannot conclude that one of the alternative regulatory models reduces incremental costs more than any other.

Registrants

1. Registrants uniformly reported that they incur incremental pre-trading expenditure. As a result, registrants assessed the commercial opportunities in each jurisdiction before deciding to seek registration in that jurisdiction. In some instances, registrants were not able to generate positive returns in the short term.

2. While material incremental compliance costs were not the norm for our case study participants, smaller firms are less able to bear these costs and consequently are more likely to find them to be material. Thus, the existence of multiple securities regulators in Canada may impose a competitive *dis*advantage on smaller firms.

3. Investment firms have experienced significant delays during the registration process at the level of the firm and individual employees. Further, these firms have lost clients and encountered barriers to entry due to the existence of multiple securities regulators in Canada.

4. In general, each of the regulatory models would likely reduce incremental costs although it is not possible to determine with any degree of certainty which model would lead to the greatest reduction.

Initial Public Offerings

1. The most significant issue that may adversely affect an IPO is opportunity cost risk. For one case study participant, regulatory impediments arising from a non-principal jurisdiction contributed to the issuer's foregoing an opportunity for growth which, if taken, would have resulted in a significant delay to its IPO as a result of existing

regulatory requirements. Further, in all cases, issuers were exposed to a minimum of five incremental working days in delay.

2. Case study participants provided examples of events beyond their control that could have materially reduced the pricing of their securities if regulatory delay had affected the point at which pricing took place. Some of these events were unexpected and highlight the time-sensitive nature of an IPO.

3. Because we have not found material incremental costs with respect to the IPOs that we examined, we have no basis on which to conclude that one model is preferred to any other or even that any of the alternative models is preferred to the current system.

Exempt Market Transactions

1. Issuers engaging in exempt distributions target investors regardless of the jurisdiction in which investors reside. Generally, they will not seek to avoid certain jurisdictions or restrict the number of jurisdictions in completing their respective transactions.

2. Incremental transaction costs will be broadly similar at every level of capital raised (e.g. short-term debt, long-term debt and equity) regardless of the security issued.

3. Material incremental compliance costs were not the norm for our case study participants. However, smaller issuers are less able to bear these costs and consequently are more likely to find them to be material. Thus, the existence of multiple securities regulators in Canada may impose a competitive *dis*advantage on smaller issuers.

4. One case study participant reported that it would have excluded certain jurisdictions from its offering had its applications for exemptive relief been refused in those jurisdictions.

5. In general, each of the regulatory models would likely reduce incremental costs although it is not possible to determine with any degree of certainty which model would lead to the greatest reduction.

Acquisition Transactions

1. In acquisition transactions where regulatory hearings were held, case study participants reported opportunity cost risk which related to the delays that may arise if multiple regulators are involved in the hearings. We also received anecdotal feedback which suggests that target companies in a hostile takeover bid can engage in "forum shopping" in order to increase the acquirer's opportunity cost risk.

2. In order for incremental cost savings to be realized, any model including the current system must ensure that hearings are held promptly with decisions rendered in a time-efficient manner and with no opportunity for forum shopping. Because issuers under the passport system and a single regulator model deal with only one regulator, there seems to be more scope under these models to accomplish this objective.

The Costs of Compliance in Canada's Securities Regulatory Regime[1]

1. Introduction

(a) *Purpose*

We understand that the WPC's mandate is to complete an independent assessment of the securities regulatory structure that will best serve Canada's interests. We understand that the WPC is reviewing and assessing strengths and weaknesses of the current system and intends to recommend an appropriate regulatory structure with a governance model and accountability framework. We also understand that the recommended structure "must meet objectives which include providing for sound investor protection and creating confidence that the highest regulatory standards are rigorously and equally enforced, while fostering efficient, dynamic and innovative capital markets for businesses of all sizes without an undue regulatory burden."[2]

At the request of the WPC, we sought to determine the costs associated with complying with a regulatory regime in which there are both multiple regulators and inconsistencies in securities regulation among provincial and territorial jurisdictions. In accordance with our mandate, we analyzed the costs imposed upon Canadian capital market participants arising from the current securities regulatory structure and assessed how these costs would differ under the alternative regulatory structures described below. We arrived at these terms of reference after consultation with staff of the WPC prior to the commencement of our research.

(b) *Methodology*

As noted above, our mandate was to analyze the differential costs associated with the current securities regulatory structure relative to alternative structures, including: the proposed passport system of regulation, uniform securities legislation and a single national securities regulator. Thus, we considered incremental costs from the standpoint of various capital market participants, specifically issuers and registrants.

We defined "incremental costs" as costs incurred by the issuer or registrant that would not have arisen if the issuer or registrant needed to comply only with the securities laws of its province or territory in conducting business throughout the country. Where we found those incremental costs to be material, we considered whether alternative regulatory models possess the potential to reduce those costs. We generally have not provided further analysis where incremental costs were found to be immaterial.

Relatively speaking, some incremental costs are easier to identify than others. For example, legal fees incurred as a result of the need to review the securities legislation of multiple jurisdictions before undertaking a transaction are clearly incremental since this specific cost would not have been incurred but for the existence of multiple regulators with differing

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1 We gratefully acknowledge the tireless research assistance provided by Marc Paulez and Sarah Rancier who committed themselves to this project and worked effectively towards its completion.

2 See website of the WPC, online at http://www.wise-averties.ca/about_en.html.

legislation. On the other hand, specifying, for example, which prospectus-filing fees are incremental and which are not requires a benchmark against which we can measure current prospectus filing fees. Where no benchmark exists, we have considered the materiality of the estimated *gross* cost.

To conduct our analysis of incremental costs, we investigated a series of case studies in four different areas of securities regulation selected in conjunction with the WPC. Three specific examples in each area were studied to discern whether there may be incremental cost savings if provincial and territorial jurisdictions moved to one of the three alternative models. In particular, we were directed to examine incremental costs based on issues arising from:

- The registration process;
- Initial public offerings (IPOs);
- Exempt financings; and
- Acquisition transactions.

We understand that these areas were chosen to represent a cross-section of intermediary and issuer activity subject to securities regulation. In certain cases, we identified the specific transactions to be studied by reviewing lists of recent transactions and approaching the issuer or its counsel to participate in the study. We also approached counsel at various law firms across the country to discuss, on a general basis, transactions that occurred in 2002 which we might place on our list of transactions to consider. In selecting transactions, we attempted to canvass a range of transaction sizes. We also attempted to ensure that the selected transactions were "national" in scope and not confined to any one jurisdiction.

Using a standard set of questions, we conducted 12 interviews with members of senior management of both issuers and registrants. In certain cases where representatives of the issuer were unavailable, we spoke with its legal counsel. To encourage disclosure of information relating to costs, we agreed with these individuals to retain confidentiality of information they provided (including their names and details of the transactions discussed). The standard list of questions was forwarded to the interviewees in advance of a scheduled interview. Two members of our research team conducted each interview in person where possible and otherwise by telephone. Each interview lasted approximately 90 minutes.

Using this information, we examined those costs that were incremental and assessed the materiality of those costs. Where the costs were material, we attempted to determine the extent to which those costs would have been borne under the alternative models. The process of determining the extent to which incremental costs (and opportunity cost risk) would have been borne under the alternative models is itself subject to uncertainty. It is possible, for example, for *gross* costs and opportunity cost risk to vary, positively or negatively, from the current regime. The reason for this is that the effect that an alternative regulatory model will be dependent, *inter alia*, on the following factors:

- The complexity of the regulation. We expect there to be a correlation between the complexity and pre-trading expenditure, compliance costs, and opportunity cost risk; and

- The responsiveness of the regulator(s) (i.e. the regulator's speed in responding to any filings such as registration applications or applications for exemptive relief).[3]

Any reduction in material incremental costs and opportunity cost risk (or reduction in gross costs in the case of a single regulator) would have to be weighed against transition costs that would be incurred due to a change in regulatory regime. We would further expect these transition costs to be unevenly borne by market participants. However, the case study approach could not capture expected transition costs.

We focused on material incremental costs only. Materiality is a financial concept and represents a cut-off point below which amounts are insignificant in their context. Materiality is distinct from the absolute size of an amount, and consequently an amount that is material to a smaller firm may be wholly immaterial to a large, multinational company. We have therefore not provided an analysis of incremental costs where these were found to be immaterial. Such costs do not adversely affect either the financial performance or the market value of market participants nor would they influence the course of normal strategic business decisions.

The concept of materiality depends greatly on the context in which it is used. For example, materiality in an accounting audit depends on the circumstances of a company but could be between 1 to 2% for capital items and up to 5% for income. Under securities legislation in some jurisdictions, the definition of material change refers to a change in the business, operations or capital of the issuer that would reasonably be expected to have a significant effect on the market price or value of any of the securities of the issuer. Thus, the costs on any individual transaction may appear large when viewed in isolation but will often be immaterial when considering the overall financial situation of the firm involved.

We classified costs according to whether they are capital or revenue in nature. This classification allowed us to determine which measure – balance sheet or profit and loss – these costs would be compared to in order to determine materiality. We initially set a threshold level of ½ of 1% of transaction value for capital costs and 1% of net profit for revenue costs, both of which are very narrow (i.e. more likely to result in a finding of materiality) compared to the examples given above. As will be discussed later in this report, however, we generally found that the actual incremental costs were well below this threshold. Finally, for some costs, the use of a materiality threshold is inappropriate. In those cases, we used other measures to determine the impact of those incremental costs on case study participants.

We scrutinized the pre-trading expenditure, compliance costs, transaction costs, and opportunity cost risk associated with the current regulatory regime and considered how they

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[3] However, this level of uncertainty may be somewhat lower under the passport and USL models than under a single national regulator due to possibility of a virtuous cycle of regulatory competition. We were not mandated to examine regulatory competition though we believe that various iterations of this model would add significantly to the debate.

might change under regulatory alternatives.[4] Further detail relating to the costs we considered includes the following:

- Pre-trading expenditure was assessed in terms of the net revenue that is generated subsequently. The reason for considering net revenue on an ongoing basis is that pre-trading expenditure does not merely permit the generation of the current year's net income but also all future years' net income;

- Opportunity costs are by definition subject to estimates, and consequently this report focuses on opportunity cost risk. Opportunity cost risk refers to the risk that business may be lost or delayed due to regulatory requirements. The consequence of lost or delayed business can have a material adverse impact on the financial performance or capital structure of a firm. We therefore assessed opportunity cost risk by the use of qualitative feedback that we received from case study candidates;

- We captured information relating to the incremental employee-days incurred due to the existence of multiple securities regulators. "Employee-days" is a measure equalling the work one employee produces in one day. Incremental employee-days can arise from incremental pre-trading expenditure and incremental compliance and transaction costs. The purpose of gathering this information was to determine the extent to which registrants and issuers are over-staffed; and

- Indirectly, we also attempted to form an opinion as to whether external advisors are over-staffed, though the true picture can only be assessed by aggregating the total number of incremental employee-days incurred arising from advisory services provided to *all* their clients.

Although this study focuses on the costs to issuers and registrants, we acknowledge that investors also bear costs of the current regulatory regime, indirectly through their investments. However, we have chosen to focus primarily on issuers and registrants as these entities bear most of the direct costs of the regulatory regime.

(c) *Regulatory Models Considered*

As noted above, we examined costs inherent in the current system of regulation and compared these to costs arising under alternative systems, including the recently proposed passport system of regulation, uniform securities legislation, and a single national regulator. In this section, we outline primary characteristics of the current system and of each of these models.

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4 Another definition of incremental costs is that these costs include: costs relating to disparate substantive rules among the provinces, disparate administrative practices among the provincial securities regulators, multiple regulators with overlapping jurisdiction, opportunity costs to investors and intermediaries represented by domestic and foreign issuers who choose to bypass the Canadian capital market in favour of foreign markets with more uniform regulatory systems, and lost economies of scale in the development and administration of substantive regulations and regulatory policy by multiple jurisdictions. See A. Douglas Harris, "White Paper: A Symposium on Canadian Securities Regulation: Harmonization or Nationalization?" (2002) at 80.

(i) The Current System

Securities regulation is set forth in provincial legislation. Each province and territory develops its own laws and policies with no obligation to co-ordinate its regulation with the laws of any other jurisdiction. These laws are administered and enforced by a provincial or territorial securities regulatory authority. The existence of 13 separate regulatory regimes, each administered by a separate regulator, has resulted in a fragmented system of securities regulation throughout Canada. For example, an individual or firm seeking to become a registrant must register in each provincial or territorial jurisdiction. Similarly, an issuer attempting to complete an exempt offering on a national basis must ensure that the transaction falls within an available exemption in every jurisdiction even though the exemptions in all jurisdictions may not be identical. Further, separate fees may be payable to each provincial and territorial regulator.

The Canadian Securities Administrators (CSA) seeks to develop a national system of harmonized regulation, policy and practice.[5] The CSA is an informal body, which functions through meetings of regulatory representatives, communications between executive directors and staff of each of the regulators, and inter-regulatory committees formed to oversee joint initiatives.

The CSA has introduced several initiatives that reduce the costs of a fragmented securities regime to market participants, including: the Mutual Reliance Review System (MRRS); the National Registration Database (NRD), the Registration Streamlining System, the System for Electronic Disclosure by Insiders (SEDI) and the System for Electronic Document Analysis and Retrieval (SEDAR) to name a few.

In addition, while the CSA is by no means a national securities regulator, it has promulgated national and multilateral instruments, which can be subsequently adopted as law by regulators in each of the 13 jurisdictions. National and multilateral instruments have resulted in harmonized provincial laws in such areas as mutual fund regulation, takeover bids, registration and alternative trading systems.

Nevertheless, while the CSA has facilitated a certain level of harmonization, there are limitations on its overall ability to coordinate securities regulation:

- As the CSA is a purely voluntary organization, its members are accountable to no entity. Each regulatory body can exit the organization any time and bears no obligation to approve and implement a policy or rule adopted at the CSA level;

- Provinces and territories retain the ability to insist on their own distinct approaches rather than devising common solutions to coordinate regulatory initiatives;

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5 See website of the Canadian Securities Administrators, online at http://www.csa-acvm.ca/html_CSA/about.html#mission.

- CSA members can have differing philosophies regarding the objectives and structure of securities regulation;[6]

- A time lag exists in instituting national initiatives, which results from the need for 13 different regulatory bodies to reach agreement on policy directions, specific requirements of the initiative and formal approval processes;

- The legal status of CSA initiatives differs from jurisdiction to jurisdiction. Market participants often require external advisors to assist them in determining the status and substantive content of CSA instruments. Different steps are required to ensure compliance with a nominally harmonized regulatory approach; and

- As the CSA has no enforcement powers, ad hoc coordination among regulators on an issue-by-issue basis is necessary.

Despite these limitations, the CSA's initiatives have been important in streamlining the regulatory regime. For example, the MRRS permits one regulator to rely on the analysis and review of another regulator so that the applicant receives comments and a decision from only one regulator on behalf of all others. The applicant thus deals only with one regulator as opposed to 13 if non-principal regulators do not exercise their ability to opt out. The MRRS has allowed for a greater level of harmonization than that which existed prior to its inception areas such as exemptive relief applications, prospectus approvals and registration applications, reinstatements and renewals.

However, the MRRS has drawbacks, some of which relate to costs to market participants. These include:

- The MRRS does not alleviate the necessity for market participants to pay fees in each jurisdiction;

- It does not imply that each regulator needs to surrender its jurisdiction but is instead based on voluntary cooperation. Thus, a regulator can opt out of the system at any time and deal with the market participant directly; and

- Because securities laws are not uniform in each jurisdiction, market participants often must obtain advice on legal requirements in each jurisdiction.[7]

(ii) Passport System of Regulation

A passport system of regulation would enable jurisdictions to delegate authority to a securities regulator in another jurisdiction. As a formal delegation model, the passport system would move Canada from a voluntary system of mutual reliance under MRRS to an obligatory one, wherein provinces and territories could not opt out. The extent of delegation under a

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6 Five Year Review Committee, "Reviewing the Securities Act (Ontario)" Final Report (2003), at 33-34, online at www.osc.gov.on.ca/en/regulation.html.

7 *Ibid* at 36.

passport system of regulation can vary. For example, a robust passport system could be based on comprehensive mutual recognition of decisions of a lead or "primary" regulator. Under a less robust passport system, jurisdictions could opt out in certain instances, such as in the monitoring and enforcement of a matter. There are other iterations of the passport system which are discussed in comment letters submitted to the WPC.[8]

Recently, provincial ministers issued a Discussion Paper in which they propose a passport system of regulation.[9] Under the model, jurisdictions enter into agreements pursuant to which one jurisdiction would recognize the decisions made by another on the basis of the rules applicable in the latter. The system is premised on the notion that there will be "host regulators" and "primary regulators". Host regulators are those in the jurisdiction where the market participant is operating or offering securities. Primary regulators are those that bear the responsibility to oversee the market participant. Under the proposed passport system, registrants and issuers would need to meet the requirements of the primary regulator only.[10]

The proposed passport system is intended to apply to a range of areas, including: granting registration, issuing prospectus receipts or exemptions, reviewing continuous disclosure information and monitoring insider trading. Under the system, issuers and registrants would be permitted to operate anywhere in Canada, provided they meet the eligibility criteria to operate in one jurisdiction. Specifically, filing requirements of the primary jurisdiction would be deemed to be the requirements of a host jurisdiction for the purpose of complying with the host jurisdiction's legislation. Moreover, the approval of the primary regulator would be deemed to be approval from the host regulator, subject to the payment of fees, which would be done through a single electronic transaction.

The proposed passport system would be mandatory and therefore does not allow "opt outs" in the way that the MRRS permits. However, the proposed model is flexible to some extent. First, not all jurisdictions would be required to participate as a primary jurisdiction; a province or territory can delegate or assign responsibility for regulating entities to another jurisdiction if it chooses not to participate as a primary jurisdiction.[11] Secondly, provinces and territories will continue to have the ability to implement measures to meet local and regional capital market needs (such as being able to respond to the needs of a concentrated number of issuers in a specific industry sector in the jurisdiction).

The proposed passport system is a workable solution to inefficiencies in the current system if the provincial and territorial jurisdictions co-operate in the implementation of the system. Such co-operation may include increased harmonization of securities laws but will definitely necessitate agreements executed among provincial and territorial jurisdictions under which jurisdictions agree to delegate authority to each other in the manner described above.

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8 See, for example, the comment letter of Jeffrey MacIntosh. Jeffrey MacIntosh, submission to WPC.

9 "Securities Regulation in Canada: An Inter-Provincial Securities Framework" Discussion Paper of provincial ministers, online at http://www.revenue.gov.ab.ca/publications/securities_regulation/discussion_paper.html [hereinafter "Discussion Paper"].

10 *Ibid* at 10.

11 *Ibid.*

(iii) Uniform Securities Legislation

The CSA recently published for comment a concept proposal for uniform securities legislation (USL). The primary objective of USL is harmonized legislation across provincial and territorial jurisdictions. The USL proposes to meet this objective through:

- A streamlined system for inter-jurisdictional registration of firms and individuals;
- A civil liability regime for secondary market participants; and
- A streamlined securities act with details contained in rules so that further amendments can be made through the rule-making process.[12]

In addition, the USL envisions a system in which the issuer submits the required fees for each jurisdiction from which it seeks a receipt to the principal regulator only. The principal regulator would be responsible for distributing the fees.

Under the USL, a person or company would only be required to register when they trade in securities. Registration would be limited to two categories: dealers and advisors. The registration system would be streamlined, as it would only require registration with one jurisdiction – the home jurisdiction. Fees for access to other jurisdictions would be paid to the home jurisdiction. The requirements regarding content of prospectuses would be harmonized. Capital-raising exemptions would be unified. Offers made under a formal bid would be exempt from early-warning requirements. Contravention of any provision would constitute an offence.

Under the CSA's current draft of the USL, the system contemplated is not completely uniform. For example, certain exemptions to purchasers outside of the home jurisdiction are not harmonized. Further, while Multilateral Instrument 45-103 relating to exempt distributions has been adopted by many jurisdictions, it has not received universal acceptance among Canadian provinces. In order for our analysis of USL to be as rigorous as possible, we considered USL as it is contemplated in theory; that is, we have considered the ideal system as envisioned by its authors. Ideally, these instances of lack of uniformity would give way to completely harmonized legislation as well as processes to which issuers are compelled to adhere.

A further condition for the workability of a robust USL system is that the legal status of harmonized regulation is consistent across all jurisdictions. As noted above, current CSA legislative initiatives do not necessarily have the same status.[13] The lack of coordination among jurisdictions raises the question of how new policy and legislative initiatives would be proposed and approved under the USL system. Its efficacy would certainly be diminished if individual jurisdictions continue to retain the ability to implement and amend CSA legislative initiatives on their own schedule and in their own way.

One of the ideals of the USL is its contemplation of inter-commission delegation. The delegatee commission would assume the regulatory responsibilities of the commission

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[12] (2003) 26 OSCB 941.

[13] Osler Hoskin & Harcourt, submission to WPC.

delegating. In an IPO, for example, the issuer would deliver the preliminary prospectus to one regulator and would deal only with that regulator during the review process. The issuer would receive a receipt from one regulator only and regulators' ability to opt out of the system would be eliminated. The receipt would be effective in all jurisdictions that have delegated their ability to review prospectus filings to that regulator.

In contemplating delegation among jurisdictions, the CSA's proposed USL bears some similarities to the passport system. Like the passport system, it envisions willingness on the part of one jurisdiction to make decisions on behalf of all others. In addition, both systems permit regional differences to be reflected in the regime to some extent. The USL allows the existence of local rules and the passport system permits "acceptable departures" from the regime. Both proposals attempt to recognize that local markets in Canada may have their own policy imperatives.

Despite these similarities, the USL and passport systems are fundamentally different. Delegation in the USL context is preceded by the implementation of harmonized legislation preventing opt-outs whereas the passport system does not (at least at this stage) require harmonized legislation to function. For example, the USL requires agreement among all jurisdictions regarding available exemptions, categories of registration, the format of a prospectus and other disclosure documents. Such uniformity is not necessarily required under the passport system as regulated entities could adhere only to the rules of the primary jurisdiction. However, we note that the Discussion Paper indicates that a greater degree of harmonization than that based on common principles may be necessary to reduce the potential for jurisdictions to decline to join or withdraw from the passport framework because of dissatisfaction with the application of different laws.[14]

Furthermore, the continued existence of multiple regulators under USL means that jurisdictions can apply the law differently (even though the law may be harmonized). Differing philosophies among securities regulatory authorities may exacerbate this potential problem, preventing true uniformity from being achieved. The differing application of a uniform securities law among jurisdictions is not an issue under the passport system which permits jurisdictions to retain differing rules as long as there is comprehensive mutual recognition of securities laws. Furthermore, the CSA's draft USL permits the existence of local rules, which first principles suggest is incompatible with "pure" USL.

(iv) Single Regulator

Over the past 40 years, numerous proposals for a revamped securities regulatory regime have called for the establishment of a new institutional structure for the administration and enforcement of securities regulation, with authority to do so embodied in a national securities regulator of some sort. These proposals include suggestions for the establishment of: :

- A federal securities commission that administers federal law with provincial commissions to administer provincial laws;[15]

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[14] Discussion Paper, *supra* note 9 at 9.

[15] Porter Commission, "1964 Report of the Royal Commission on Banking and Finance" (1964).

- A federal commission administering provincial laws; [16]

- A "pan-Canadian" commission under which there would be no central federal regulator but a regulator comprised of representatives from each of the provincial commissions;[17]

- A federal commission administering federal law for interprovincial and international issues combined with provincial commissions administering provincial laws for intraprovincial issues;[18] and

- A federal commission administering federal law and provincial law for intraprovincial, interprovincial and international issues with provincial commissions administering other limited matters.[19]

In contemplating a "single regulator," this study assumes a model in which all provincial powers over securities regulation are devolved to a national regulator with one single legislative regime. We adopt this model because it enables us to discern the costs and benefits of moving from the current system to a national commission more easily than models in which powers are split between provincial regulators and a federal regulator.

2. Registration

(a) *Background*

Securities legislation provides that no person shall trade securities, underwrite securities issuances or give advice with respect to securities investments unless the person is registered.[20] These "registrants" are subject to regulatory requirements. Non-compliance with these requirements can lead to penal sanction or other sanctions such as reprimand, suspension, cancellation or restriction of registration.[21] In order to become a registrant, a person or company must file a registration application in the prescribed form. The forms elicit information relevant to assessments of the applicant's financial responsibility, integrity and competence. Typically, firms must apply annually for renewal of their registrations. Individuals no longer must renew their registration under the National Registration Database (NRD)[22] though an annual fee remains payable.

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16 OSC, "CANSEC – Legal and Administrative Concepts" (November 1967) O.S.C.B. 61 at 63, 65.

17 David Brown, "Defining Securities Regulation" in OSC Annual Report (2002), online at http://www.osc.gov.on.ca/en/About/Publications/AnnualRpt2002/en/messages_chair.html.

18 Canada, Minister of Consumer and Corporate Affairs (1979), 1979 *Draft Act,* s. 1.02.

19 *Supra* note 6 at 8.

20 A.S.A. s.75(1); B.C.S.A. s.34(1); M.S.A. s.2(1); NB.S.F.P.A. s.5(1); Nfld.S.A. s.26(1); N.S.S.A. s.31(1); N.W.T.S.A. s.4; O.S.A. s.25(1); P.E.I.S.A. s.4; Q.S.A. s.148; S.S.A. s.27(1); Y.S.A. s.3.

21 A.S.A. s.198(1); B.C.S.A. s.161(1)(f); M.S.A. s.8; NB.S.F.P.A. ss.22, 23; Nfld.S.A. s.28; N.S.S.A. s.33; N.W.T.S.A. s.10; O.S.A. s.127 1 and 6; P.E.I.S.A. ss.18,19; Q.S.A. s.273; S.S.A. s.134(1)(i), (j); Y.S.A. s.8(2).

22 Charles River Associates, "Estimating the Incremental Costs of Multiple Securities Regulators in Canada" (2003) at note 38 [hereinafter "*CRR*"].

This system of regulating registration can be costly because registrants are required to file their registration applications and renewals with each provincial or territorial securities regulator. The form differs between jurisdictions and each jurisdiction requires a separate filing fee to accompany each application. All registrations are completed on paper-based forms and the approval process can take up to six weeks during which prospective registrants may lose revenue opportunities.

Without doubt, the registration system in Canada imposes incremental costs on individuals and firms to become registered and to maintain their registrations. Individuals and firms seeking to trade securities must be registered with each of the securities regulators where their clients reside. This could result in 13 different applications to 13 different regulators. The Charles River Report (CRR) estimates that IDA members devoted $4.2 million annually in internal labour resources to firm and individual registration tasks.[23] Also, registrants face ongoing compliance costs.

The NRD will certainly achieve some cost savings for dealers and advisors since they will be able register electronically in every jurisdiction simply by filing one form and paying a single fee.[24] By screening out common deficiencies before delivery to the regulator(s) and eliminating the movement of paper, the NRD will likely reduce the time of the approval process. Notably, however, the NRD is not national in scope; Québec is not part of the NRD so separate filings must continue to be made for registrations in that province.

(b) *Review of Existing Literature*

The CRR considered the costs associated with having 13 securities regulators compared to one national regulator with four regional offices. It noted that there is a relationship between the costs of registration and the number of jurisdictions in which a firm is registered. These increased costs are borne disproportionately by smaller market participants that, unlike larger firms, are unable to exploit the economies of scale (e.g. larger compliance departments that are better equipped to absorb additional responsibilities). While it does not appear that the current regulatory regime has acted as a barrier to entry for new competitors,[25] there are inefficiencies in the current regime.[26]

Among other things, the CRR explored internal resources that would be saved by IDA members if they were regulated by one commission. It concluded that the internal savings to intermediaries would be $4.2 million per year. The CRR stated that the survey respondents had differing views regarding the potential savings available to them under NRD with the average reported savings available from NRD being 38%.[27]

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23 *Ibid* at vii.

24 Multilateral Instrument 31-103 *National Registration Database*, Ontario Securities Commission Rule 31-509. See also NRD website, online at http://www.nrd-info.ca/en/index.htm.

25 CRR, *supra* note 22.

26 This indeed was the conclusion of Phillips, Hager & North Investment Management Ltd., Canada's largest privately owned investment advisor in a comment letter to the WPC. Phillips, Hager & North Investment Management Ltd., submission to WPC.

27 CRR, *supra* note 22 at viii.

It is clear that the NRD has eliminated some of the duplication and inconsistencies that existed under the previous individual-registration regime. First, one application now covers all provincial commissions except Québec, replacing 12 possible registrations (though in practice it is rare for an individual to register with so many commissions). Secondly, the NRD allows for permanent registration across jurisdictions whereas most, but not all, jurisdictions previously required annual renewals.

The Ontario Securities Commission (OSC) estimated the gross economic benefits of the NRD to the Canadian financial services industry to be $85 million in present value over a five-year period.[28] The present value of operating and development costs over the same period is predicted to be $47 million. These cost savings were attributed to internal cost savings rather than lower fees charged by the commissions. Indeed, not only would the current fee structure remain in place but the need for individual commissions to approve each registration application would also continue. Despite the lack of an MRRS for individual registration applications, the CSA nevertheless predicted that the current time lag of four to six weeks would be reduced to a matter of days.[29]

While we acknowledge the potential for cost savings under NRD, its establishment is relatively recent. Therefore, it is impossible to know precisely what its long-term benefits will be. Our approach has been to consider costs that firms incurred to register themselves and their employees in 2002. Where possible, we discussed with registrants those areas where costs might have been reduced under the NRD.

(c) *Case Studies*

For three registrants, we analyzed pre-trading expenditure, compliance costs, opportunity cost risk, and incremental employee-days. We found that:

- Where registrants decided to register their firm and employees in a particular jurisdiction, they have not always succeeded in generating marginal net revenue that exceeded their pre-trading expenditure, i.e. the benefits did not consistently exceed the up-front costs. Further, registrants that consistently evaluated opportunities on a jurisdiction-by-jurisdiction basis were deterred from registering in certain jurisdictions where opportunities were judged to be sparse;

- In one case, incremental compliance costs were material. From an economic perspective, this represents a poor use of the registrant's limited resources;

- Registrants experienced significant lags in obtaining both firm and employee registration, encountered barriers to entry, and lost existing business. As a final point, competition may also be adversely affected, though we have not confirmed this; and

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28 The Office of the Chief Economist at the OSC contacted over 700 registrant firms using registration information from several provinces. A total of 131 firms responded, representing over 47,000 registrants, or nearly half the registrant population of Canada (excluding Québec). A sample this comprehensive should have an error rate of less than 1%. See NRD website, *supra* note 23.

29 *Supra* note 24 at 2.

- Over-staffing varies directly with the number of jurisdictions in which the registrant and its employees are registered. We did not observe any significant over-staffing, however.

We discuss each of these points in greater detail below.

(i) Pre-Trading Expenditure

We classified certain costs associated with the requirement to register in each jurisdiction as pre-trading expenditure. Pre-trading expenditure can be characterized as capital expenditure insofar as it is incurred not in respect of any *particular* accounting period but rather in respect of the total net income generated *over the life* of the registrant's activities. Pre-trading expenditure is by definition a one-off item, unlike registration fees which are consumed during the year and renewed annually.[30] We considered pre-trading expenditure with reference to:

- The present value of the registrant's net income generated in the relevant jurisdictions; and

- Whether the expenditure is sufficiently large as to constitute a barrier to entry for new firms in the industry.

Based on the responses we received from the three case study participants, we found that incremental pre-trading expenditure varies according to the number of jurisdictions in which registration is sought, and that it is further increased by the differing informational requirements of the various securities regulatory authorities.

Present value of firm's net income generated in jurisdiction

In most cases, the firm's marginal net revenue of the current year exceeded incremental pre-trading expenditure and therefore generated meaningful returns to the registrants. The net present value of the marginal net income that may be generated during the life of the registrant (i.e. beyond the current year) will only add to the returns made possible in the first instance by pre-trading expenditure that enabled the firm to affect its registration and those of its employees.

We did receive some feedback to indicate that, in certain instances, returns to date were not sufficient to compensate for pre-trading expenditure incurred. The existence of multiple securities regulators has therefore contributed to negative returns accruing to registrants. In the longer term, however, registrants may be able generate sufficient income to reverse this situation.

Two case study participants also commented on the need to assess opportunities on a jurisdiction-by-jurisdiction basis (the third allows its employees to decide the number of jurisdictions in which to register). They considered whether to register in a particular jurisdiction, and how many employees would be registered in the jurisdiction. Therefore, where business opportunities are judged to be sparse, incremental pre-trading expenditure

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[30] Our analysis of pre-trading expenditure differs from other analyses in this report as we have not assessed its materiality in the context of the first year's marginal revenue generated as a result of becoming registered, nor have we measured pre-trading expenditure against the company's balance sheet.

(and filing fees) may have the effect of deterring registrants from seeking business in those jurisdictions. Such decisions reduce the choice available to issuers and investors in smaller jurisdictions and reduce competition in smaller jurisdictions.

Barriers to Entry

We cannot say with absolute certainty that pre-trading expenditure *per se* is not a barrier to entry. However the absolute amounts involved do not suggest that it is prohibitive. Further barriers to entry are discussed below under the heading "opportunity cost risk."

(ii) Compliance Costs

We analyzed compliance costs both in terms of the individual line items of incremental costs and the total incremental costs incurred by registrants and found that some incremental line items, and therefore total incremental costs, materially affected the financial performance of one case study. We discuss these material incremental costs below.

Incremental firm registration fees

Incremental registration fees arising from the existence of multiple securities regulators were in all instances immaterial to the results of the case study participants.

Incremental employee registration fees (pre-NRD)

Given that registration fees per employee are fixed,[31] we would expect that smaller registrants are more likely to incur material incremental employee registration fees. Smaller registrants possess fewer resources to exploit the market outside their principal jurisdiction, and may therefore have fewer clients outside their principal jurisdiction per registered employee. Further, where costs are fixed and revenue variable, costs are more likely to be material than where costs are variable. Our findings are consistent with this analysis. For example, in one instance, we found that the incremental employee registration fees had been material to the financial performance of the registrant, amounting to 3.3% of its net income. This registrant was the smallest of the three case studies.

Incremental employee registration fees (post NRD)

The effect of the introduction of the NRD will be to increase fees payable. While existing fees captured and discussed above have not been affected by NRD, registrants must also pay an additional amount in respect of NRD's development costs. All else being equal, we therefore expect our analysis of incremental employee registration pre-NRD will remain relevant. However, the desired benefit of NRD is that the increase in fees will be offset by higher internal cost savings and a reduction in opportunity cost risk.

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[31] We assumed that employee registration fees are not variable, e.g. that a registrant firm resident in British Columbia would not charge one amount to an employee based in British Columbia and a different, lower amount to an employee based elsewhere.

Because the NRD was implemented just months before the writing of this report, the firms studied had not been able to estimate the net benefit, if any, that will ultimately be realized from NRD. However, anecdotal evidence regarding its implementation and operation is relevant. One firm experienced some time-savings in using the NRD. The other firms in the case study expressed satisfaction with the ability of a new employee who was previously registered with another firm to have their registrations transferred promptly.

Case study participants also raised several criticisms of the NRD, stating that:

- The NRD suffers from poor system design;
- Conversion errors can only be amended by the IDA. There are significant lags between notification of those errors and their correction;
- The NRD merely masks the continuing differences in registration requirements across unharmonized jurisdictions, the persistence of which diminishes the ability of the NRD to reduce incremental costs;
- The NRD fees negate internal cost savings and will likely continue to do so in the near term;
- Firms incur fees to correct conversion errors for which they were not responsible. Firms must then apply for a refund of that fee, thereby increasing the demand on their internal resources to make such applications; and
- NRD is not truly national in scope as employee registrations in Québec must be completed separately.

As a general matter, we would not expect any system to operate to its full potential immediately upon introduction. Though systems require rigorous testing prior to implementation, this rarely eliminates all system defects, and end users will often experience a learning curve before they are able to fully exploit the benefits of a new system. Therefore, with the exception of the final point above, these criticisms (and related costs) may be relevant only temporarily.

Fees paid to Self Regulatory Organizations (SROs)

Registrants pay fees and other charges to SROs and exchanges. We do not consider the payment of these fees and charges to be incremental costs of the regulatory regime *per se*.[32] Further, payment of fees and charges to these bodies may not be affected by changing the structure of the securities regulatory regime. We do not expect these costs to vary significantly year to year (though larger firms would generally incur higher SRO costs than smaller firms).

We expect that registrants would belong to SROs even in the absence of any regulation. Firms may be required to financially contribute to the exchanges, and groups such as the IDA may confer a seal of quality on firms, making it commercially desirable to become members of

[32] In only one case study were gross SRO costs material, just breaking the materiality threshold of 1% of net profit. Though we could not separately identify the incremental costs, these would appear to be immaterial.

those organizations. Therefore, we must be careful not to assume that all amounts payable to SROs and exchanges are incremental costs arising from the existence of multiple securities regulators.

Recurring incremental legal and professional fees

Incremental recurring legal and professional fees arising from the existence of multiple securities regulators were in all instances immaterial to the results of the case study participants.

Recurring incremental internal costs

Recurring internal costs cover a broad spectrum, including:

- administrative costs to complete paperwork for both firm and employee registrations;
- costs related to time spent to track regulatory changes:
- costs in terms of time spent to respond to industry initiatives; and
- other sundry costs.

Recurring internal costs were material in only one of the three firms interviewed. However, the firm's responses suggested that it expects these costs to decline due to learning-curve efficiencies and expected gains arising from the implementation of the NRD. It is possible that declining incremental costs coupled with rising net profit due to growth in the business may render these costs immaterial in the future. This final observation is consistent with the belief that smaller firms are more likely to incur material incremental costs than larger firms.

Anecdotal evidence suggests that registrants face challenges in managing their regulatory compliance and risk. The firms interviewed stated that:

- Some jurisdictions require applications to be filed with the commissions themselves, others with the IDA;
- Some jurisdictions require fees to be paid to the commissions themselves, others through the IDA;
- Some jurisdictions require certain documents to be filed annually while others do not; and
- Some jurisdictions require filings in a particular format while others require another format.

This is not intended to be a complete list of issues that give rise to incremental costs, but rather to give a flavour of the challenges faced by registrants in managing their regulatory compliance and risk.

Total incremental costs

We found that total incremental costs, excluding pre-trading expenditure were material to the smallest of the case study participants, representing 8.4% of net profit. As previously noted, these costs were driven in part by the incremental internal costs that this case study participant expects to decline in the future. The remainder was primarily due to the relatively fixed nature of employee registration fees that are not expected to decline, i.e. total incremental costs will remain material to this case study participant, subject to future growth in profitability.

In respect of the other two case study participants, the immaterial incremental line items were also not material in aggregate, representing 33 basis points of net profit. Incremental costs for these two participants would have had to increase in percentage terms by a factor of three to reach the materiality threshold.

(iii) Opportunity Cost Risk

Incremental business days required to complete registration applications

We asked the firms how many business days were required to prepare, review and submit applications for firm and employee registrations. We sought to identify whether applications could be completed within a reasonable amount of time. When added to the time required to obtain registration, this was relevant to determining the total "idle" time the firm or employee must wait before engaging in trade.

The responses from the firms interviewed varied between five and 20 business days for firm applications, and up to five business days for employee applications. Given the delays in registration noted below, we do not consider the time required to prepare, review and submit applications to be the critical delay experienced by firms seeking registration. We have therefore not formed an opinion on the variances noted above nor have we considered whether registration applications strike the appropriate balance between stakeholder protection and the economic interests of registrants.

Delays in registration

In discussions with the firms, we attempted to capture not only the length of time required to obtain firm registration but also the time it took the commissions to respond to the submission of an application. The responses we received suggest that it took an average of three months for the firms in our case studies to receive a first response from the commissions in respect of firm registrations. The time required to register an employee similarly imposed an opportunity cost on firms in our case studies.

In particular, we found that there were delays experienced by the firms interviewed with respect to both firm and employee registrations. The delays included:

- Approximately 170 business days taken by one commission to respond to the firm's application for registration. This application was ultimately approved 11 months after the application was initially submitted;

- A 17-month gap between the submission of a registration application and its subsequent approval;
- Six months to obtain the necessary registration to open an office in another jurisdiction; and
- Employee registrations taking one to three weeks on average, and upwards of one year in exceptional instances.

One case study participant observed that the lack of consistency in firm application forms and procedures contributed to the risk of incomplete or deficient submissions. While the responsibility to complete a registration forms rests with the firm, the multiplicity of forms made it difficult to develop a routine that would contribute to the production of properly completed registration forms. It is clear that the submission of incomplete or deficient registration forms necessarily pushes into the future the date on which registrants may begin to trade.

We could not determine the cause of the above delays arising due to regulators experienced by firms in our case study except in one instance (the application had been lost by the commission, necessitating the re-submission of the application). There is, however, a *prima facie* case for finding these delays unreasonable and an obstacle to the conduct of their trade.

Barriers to entry

We found that registrants were generally (but not always) able to generate marginal net income in excess of their incremental pre-trading expenditure. One would expect, therefore, that firms would register in each jurisdiction where opportunities exist. However, this is not the case as there are further barriers to entry.

Two of the firms interviewed indicated that the requirement to register in each jurisdiction has either deterred or prevented them from applying for registration in certain jurisdictions. Those same firms stated that the multiple registration requirement has prevented the firm from registering in jurisdictions with lesser business possibilities/opportunities.

Case study participants also stated that the multiple registration requirement is particularly onerous when clients move from a province in which the firm is registered to a province in which it is not registered. One firm opted to close the accounts rather than obtain registration because the costs of registering in the new jurisdiction were too high relative to the benefit of maintaining a small number of clients in that jurisdiction. We comment further on this latter opportunity cost below.

Lost business

As noted above, two of our case study participants lost existing clients when those clients moved from a jurisdiction in which the firm was registered to a jurisdiction in which it was not registered. They stated that commercial logic compelled them to drop those clients rather than seek registration in the new jurisdiction. Further, given the potential time lags in obtaining registration, it is likely that even where the firm did seek registration, there would be a period

during which the firms could not provide services to those clients. It is unclear whether clients would remain with firms that could not provide seamless service across jurisdictions.

The final case study participant also commented on the transferral of responsibility for client relationships from one employee to another where the client has moved from one jurisdiction (where the first employee is registered) to another (where that employee is not registered). The risk is that a strong broker-client relationship will be lost to the detriment of both the client and the firm. The result may be the reduction of business, or the loss of the account altogether.

Reduced competition

While strictly outside the scope of our report, we note that some commentators believe that the existence of multiple securities regulators has deterred international competitors from entering the Canadian market. To the extent that this is a characteristic of the current regulatory system, the market served by registrants may be adversely affected by the reduced competition in the Canadian marketplace. Because we used a case study approach, we could not evaluate the merits of this position.

(iv) Incremental Internal and External Employee-Days

Case study participants were also asked about the incremental internal and external employee-days they incurred due to the existence of multiple securities regulators. The concept of employee-days attempts to capture the days that each staff member has worked on a particular item. It is possible for the number of employee-days to exceed the number of business days if employees are working concurrently on the same item.[33] Internal employee-days relate to staff employed directly by the firm; external employee-days related to staff employed by the firm's professional advisors.

The responses varied considerably in the reported employee-days required to complete applications for firm and employee registrations. One firm, whose employees had extensive experience with the registration process, reported approximately three employee-days for each firm registration application, while another reported 26.5 employee-days that were comprised mainly of senior management time. The amount of employee-days required to register employees did not vary significantly, however. These ranged from slightly under one day to four days per typical application (with more days required in unusual circumstances).

Due to the small number of case studies, we could not determine whether these time periods are typical. We can nevertheless cautiously offer these observations:

- Employee-days required for annual firm renewals should be lower that those experienced in preparing, reviewing, and submitting initial applications.

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[33] Incremental internal and external employee-days are a hybrid of ongoing compliance costs (captured above) and opportunity costs. It is a compliance cost insofar as the firm will incur a quantifiable expense for the work it has performed. It is also an opportunity cost as that member of staff may have otherwise been engaged in other value-added work, whether for the firm itself or for another firm to the extent that the former would be over-staffed but for the existence of multiple securities regulators.

The difference between the amount of time required for renewals and that required for initial applications are one-off "costs." Consequently, the opportunity costs of this marginal time should be minimal and should not result in over-staffing.

- The NRD potentially will eliminate some of the time required to maintain valid employee registration. If this occurs, then ongoing opportunity costs should again be minimal and there should not be any resultant over-staffing; and

- Each new registration will result in a marginal increase in employee-days required to maintain that registration on an ongoing basis.

Based on the feedback we received from our case study participants, our conclusion is that while firms do incur incremental employee-days, the extent to which they may be over-staffed will vary directly with the number of jurisdictions in which a firm and its employees are registered. However, we have not observed significant levels of internal over-staffing relative to the size of the organization.

The same may not be true in respect of their professional advisors who incur incremental employee-days not merely in respect of one client but cumulatively on behalf of all their clients. (This is also true of the three other categories of securities regulation considered in this report.) The significance of any potential over-staffing will be mitigated, however, where incremental professional fees arising from those incremental external employee-days are not material to the individual clients.

(d) ***Regulatory Models***

In this section, we set forth conclusions on whether there would be cost savings in the registration system of moving to an alternative model.

(i) Passport System

Under a robust passport system of regulation (i.e. one in which there was comprehensive mutual recognition of registration decisions), incremental pre-trading expenditure should be completely eliminated. Incremental pre-trading expenditure in the form of legal fees and internal costs would be incurred in order to satisfy differing registration requirements in each jurisdiction. A passport model that required host jurisdictions to recognize the registration granted by the primary jurisdiction (without the ability to opt out or to impose additional requirements) would eliminate the need to comply with differing registration requirements.

This development would be significant. We observed that registrants have not always been successful in generating positive returns in the near term (though this situation may reverse over subsequent accounting periods). The effect of eliminating incremental pre-trading expenditure will be to strengthen the financial performance of some registrants.

We also noted that smaller registrants may be more likely to incur material incremental compliance costs. In particular, incremental employee registration fees and recurring incremental internal costs imposed the greatest burden on the smallest case study participant.

Incremental employee registration fees, together with NRD fees, would not be reduced since employee registration fees will remain payable in each jurisdiction that an employee has elected to trade in using his/her existing "passportable" registration.[34] Under this scenario, no reduction in incremental employee registration fees would be available.

We could not determine whether recurring incremental internal costs would be eliminated. We note that while the need to separately track regulatory changes should be significantly reduced (this may also reduce recurring incremental legal and professional fees), incremental costs incurred due to regulatory enforcement may not be eliminated due to the continuing existence of multiple securities regulators.

We expect that a robust passport model would reduce incremental opportunity cost risk. We found that the current regime imposed significant delays on registrants, which should not be duplicated under the passport model due to the recognition of the primary jurisdiction's registration.

Barriers to entry should also be reduced. To the extent that incremental pre-trading expenditure is eliminated and the only incremental cost involved in entering another jurisdiction is registration fees, the "expense bar" will be lowered. Further, registrants are less likely to lose clients when they move to new jurisdictions, though this will also depend on how quickly the home jurisdiction's registration is recognized as registrants will need to provide seamless service to those clients.

In common with recurring incremental internal costs, we cannot predict with any degree of certainty whether incremental internal and external employee-days will reduce noticeably. It should, however, mirror the changes in recurring incremental internal costs. Our other observations relating to the current regime remain valid under a passport model.

(ii) Uniform Securities Legislation

Determining the effect that the USL project may have on incremental costs is subject to a higher degree of uncertainty when compared to a similar determination under the other alternative models. Reasons for this uncertainty include:

- The extent of inter-commission delegation;
- The existence of "local" rules;
- Possible differences in interpretation of regulation;
- Possible differences in enforcement; and
- Differing legal status of regulation.[35]

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34 Discussion Paper, *supra* note 9 at 1 and 13.

35 Osler Hoskin & Harcourt, submission to WPC.

This uncertainty affects not only the impact on incremental registrant costs and opportunity cost risk but also incremental issuer costs and opportunity cost risk. Nevertheless, we have based our assumptions on both the CSA's USL proposal and the manner in which a "pure" USL may operate. The extent to which the savings we find below (and under the other headings) will crystallize will depend ultimately on the robustness of the USL model.

Incremental pre-trading expenditure should be eliminated under pure USL. Whereas pre-trading expenditure is currently incurred due to the differing informational requirements which give rise to legal fees and internal costs, the existence of harmonized legislation eliminates those differing informational requirements. As with the passport model, we expect this characteristic to strengthen the financial performance of registrants.

We have also noted that smaller registrants may be more likely to incur material incremental compliance costs. In particular, incremental employee registration fees and recurring incremental internal costs imposed the greatest burden on the smallest case study participant.

With respect to incremental employee registration fees, the registration fees together with NRD fees may not be reduced. Assuming that each jurisdiction retains responsibility for, *inter alia*, enforcement under USL, a fee may be payable to cover regulatory costs associated with enforcement matters. We therefore do not anticipate that USL will reduce incremental registration fees.

We further could not determine whether recurring incremental internal costs would be reduced. We note that while the need to separately track regulatory changes should be eliminated, incremental costs incurred due to regulatory enforcement may not be eliminated due to the continuing existence of multiple securities regulators.

USL may not reduce the opportunity cost risk that case study participants have reported to us. For example, though legislation is harmonized, regulators may conduct detailed reviews of registration applications of registrants previously approved in another jurisdiction. This differs from the passport model where the acceptance of the registration applications is automatic. Therefore, USL may not provide a perceptible reduction in opportunity cost risk.

In common with recurring incremental internal costs, we cannot predict with any degree of certainty whether incremental internal and external employee-days would be reduced noticeably. Any reduction should, however, mirror the changes in recurring incremental internal costs. Our other observations relating to the current regime remain valid under a USL model.

(iii) Single Regulator

With the exception of the loss of clients who move from one jurisdiction to another, we cannot predict whether incremental costs and opportunity cost risk would be reduced. The reason for this is that the effect that a national regulator will have will be dependent, *inter alia*, on the regulator's ability to segment the market. We have found that smaller registrants are more likely to be impacted under the current regime due to the relatively fixed nature of some of the regulatory costs. A single regulator may impose a regime that lessens the regulatory burden on smaller registrants.

With respect to the loss of clients, the establishment of a single regulator will eliminate this opportunity cost risk as no further registration applications will be required in order to continue to provide seamless and uninterrupted service to those clients that move from one jurisdiction in Canada to another.

3. National IPOs

(a) *Background*

Traditionally, when an issuer wished to complete an offering of its securities to the public for the first time, it was required to obtain receipts for its preliminary and final prospectuses from each securities regulator in the provinces or territories in which it sought to complete the offering. With the introduction of MRRS, issuers typically request the appointment of a principal regulator, which provides comments relating to the offering on behalf of all other jurisdictions. National Policy 43-201 prescribes separate time limits for the issuance of comment letters for both principal and non-principal regulators with regards to both short-form and long-form prospectuses.[36]

While almost all deals go through MRRS, jurisdictions have the ability to opt out of the system and may do so in various instances, such as when they are confronted with an atypical transaction.[37] However, our correspondence with various commissions indicates that it is extremely rare for a commission to opt out of the MRRS.[38] When using MRRS, issuers must pay filing fees to every regulator; the system does not affect the requirement to pay fees to individual securities regulatory authorities. Therefore, in the IPO context, the question still arises as to the extent to which the current system under MRRS is more costly than any alternative system.

In order to launch an IPO, an issuer must incur a number of fees. It must prepare a preliminary and final prospectus. It will require the services of lawyers, accountants and an investment bank. (Professional advisors' fees represent a significant portion of IPO costs.) The issuer will also need to devote its own internal resources towards completing its IPO and incur sundry other expenses.

A further significant cost associated with IPOs is underpricing. "Underpricing" refers to the difference between the offer price and the closing price of the security on the first day of trading and is known colloquially as money "left on the table." Underpricing is significant because its existence suggests that issuers could have sold their securities at a higher price, which in turn would have resulted in higher gross proceeds.

Recent studies have compared similar-sized IPOs in Canada and the United States, where there is a more unified regulatory regime, to determine the cost effectiveness of IPOs in both countries. These studies concluded that the level of underpricing was lower in Canada than in the

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36 National Policy 43-201, ss. 5.1-5.3.

37 National Policy 43-201, section 5.4 sets forth a procedure for novel structures or novel issues.

38 Email correspondence between Anita Anand and provincial securities commissions dated August 12, 2003 and August 15, 2003 (on file with the authors).

U.S during various periods in the 1990's.[39] For example, in a study completed for the CVMQ, Suret and Carpentier reported that the weighted average level of underpricing between 1997 and 1999 in Canada was 5.11% versus 38.38% in the U.S.[40]

The corollary of this finding is that if the benefit of lower underpricing overwhelms the incremental costs of the current regulatory regime, then it would nevertheless be advantageous to launch an IPO in Canada rather than the U.S. In other words, if *overall* costs are lower in Canada, it makes commercial sense to transact here despite the fact that regulatory costs (one sub-set of the overall costs) are higher here. Notably, the underpricing studies did not identify the regulatory regime as a cause of underpricing. Similarly, we do not believe that the lower levels of underpricing in Canada are a reflection of the strength of our capital market or a product of our regulatory regime.[41] This conclusion is consistent with the Suret and Carpentier study, which linked the issue of underpricing to broker conduct.[42]

(b) *Review of Existing Literature*

Recently, the TSX conducted a detailed (unpublished) study of the costs of an IPO on the senior exchange. The TSX study examined the costs incurred by mainstream operating companies and special purpose issuers.[43] In the study, the TSX obtained its data from the IPO issuers themselves, their lawyers and accountants.

Specifically, the TSX surveyed a cross section of operating and special purpose issuers (SPIs)[44] about the costs they incurred in an IPO. The median total costs estimated by issuers are \$3.9 million for operating companies and \$10.6 million for SPIs. The key median costs estimated by issuers and the median gross offering values are as follows:

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39 Theresa Shutt & Hugh Williams "Going to Market: The Cost of IPOs in Canada and the United States" (2000); Cécile Carpentier, Maher Kooli and Jean-Marc Suret, "Initial Public Offerings in Canada: Status, Flaws and Dysfunctions" (2003).

40 Jean-Marc Suret & Cécile Carpentier, "Securities Regulation in Canada" (Working Paper, 2003) at 44.

41 One of the factors that investment bankers consider when fixing an offer price is the level at which the shares will be fully subscribed. Investment banks can bear both financial and reputational risks for a poorly subscribed IPO. Underpricing may therefore be a function of risk-adverse behaviour. Other factors, such as whether there is a "hot" or "cold" IPO market, have been shown to have a strong relationship with the level of underpricing. "Hotter" IPO markets are often more volatile and, to the extent that underpricing is risk aversion, we would expect the level of underpricing to increase. Hotter IPO markets are therefore more likely to leave money on the table. Given the relative importance of these other factors, the influence (if any) of our regulatory regime on underpricing is likely to be minimal and at least difficult to detect. Thus, while we recognize the importance of underpricing for the issuer, we will not take it into account in our study.

42 *Supra* note 40 at 45.

43 TSX, "The Costs of Going Public on the Toronto Stock Exchange" (2003) (on file with the authors).

44 "Special Purpose Issuers" are a class of legal entity that differs from "conventional" corporations insofar as their structure will generally be in the form of a trust or special purpose vehicle. Investors in SPIs finance a specific block of assets rather than the general business of a company. SPIs are also typically 'flow-through' entities, which pay out the majority of their cash inflow to investors, unlike conventional corporations which can choose to reinvest their cash inflow back into the corporation.

	Operating Companies	Special Purpose Issuers
	$'000	$'000
Offering value (gross)	39,500	116,000
Costs		
Underwriting fees	2,050	5,875
Preparation costs	88	250
Legal fees	500	888
Accounting / auditing fees	188	225
Commission fees	40	88
TSX fees	24	55
SEDAR fees	4	9
Transfer agent fees	14	18
Translation fees	24	35
Prospectus printing fees	43	125
Investor relations	88	113
Management / admin	80	23
Other costs *	175	180

* These include such items as rating agency fees and D&O indemnity premiums.

The purpose of the TSX study was to determine total costs and not the incremental costs imposed by the existence of multiple regulators. Though no analysis is possible to determine what the incremental costs may be, we can determine the materiality of those fees that are most impacted by a fragmented regulatory regime.

Total legal and accounting fees are $688,000 and $1,113,000 for operating companies and SPIs, respectively. These figures represent 1.7% and 1% of gross proceeds. Adding commission fees, SEDAR fees, and management / administration expenses to these numbers would boost these aggregated costs to 2.1% and 1.1% of gross proceeds, respectively.

Using these figures, we can see that the *aggregate* of those items that could bear incremental costs are material (using the threshold of ½ of 1%) in the case of operating companies and SPIs. Based on these numbers, we can *cautiously* extrapolate that the incremental costs of regulation for those issuers were immaterial, with a similar effect on the firm's cost of capital, if we predict that the incremental portion of these costs were less than ¼ and ½ of the aggregate costs, respectively.[45]

45 The TSX study also asked for cost estimates from the lawyers and accountants. In nearly each cost category identified above, the external advisors' estimates of costs were below the companies' own estimates. For example, the median estimate of legal fees made by lawyers advising operating companies was $225K compared to the estimate of $500K made by the companies themselves. If there is a tendency for companies to over-estimate costs, then the materiality of the relevant costs may be lower still. However, the TSX cautions against relying on these numbers because of the relative small size of their sample. The results of the TSX's study can be compared to the report from the CVMQ.

The TSX study also attempted to quantify the length of the IPO process, considering both the months to prepare for the IPO (i.e. the time required to satisfy listing requirements), and the months to complete the IPO. The TSX did not attempt to quantify opportunity costs, but rather attempted to determine the actual length of time and compare that to the companies' expectations. The median results are summarized below according to the capacity of the responder.

	Operating Companies	**Operating Company Lawyers**	**Special Purpose Issuers**	**SPI Lawyers**	**Accountants (all issuers)**
Months to prepare IPO	2.5	3.3	2.8	1.5	2.5
Months to complete IPO	3.8	5.5	3.8	3.8	4.5
Expected months to complete IPO	3.5	n/a	3.1	n/a	n/a

The TSX study did not isolate the incremental length of time required to satisfy multiple securities regulators. We note, however, the opportunity cost risk associated with missing "market windows." Consequently, companies will desire to manage this risk by limiting the length of time to prepare and complete an IPO. Often, a delay of a week or even a day may involve significant opportunity costs, and therefore the existence of multiple regulators may adversely affect companies listing on the stock market.

The TSX Venture Exchange also commissioned a survey to identify the costs of going public on the junior exchange. The survey, also unpublished, was similar to the TSX study as it considered not only the costs of listing but also ongoing compliance costs, time lags and suggestions for improvement. The report analyzes the costs according to the method chosen to obtain a listing for: a company completing an IPO; a capital pool company (CPC); and a company that is completing a reverse takeover bid (RTO).[46]

The key median costs estimated by issuers and the median capital raised were:

	IPO	**CPC**	**RTO**
	$'000	$'000	$'000
Capital raised	983	454	1,910
Total cost of listing	**99**	**87**	**191**
Costs included in the above			
Legal fees	32	29	93
Accounting / auditing fees	13	10	23
Commission fees	5	*	*

* No fees reported

46 TSX Venture Exchange, "The Costs of Going Public on the TSX Venture Exchange" (2003) (on file with the authors).

The costs borne by companies seeking a listing on the junior exchange are clearly material in the context of the capital they raised. However, the study did not analyze the costs incurred due to regulation specifically, and therefore we can express no opinion on whether the incremental costs of regulation were material to the companies.

As with the TSX study, the length of the IPO process was also quantified in the TSX Venture Exchange survey. The median results are summarized below.

	IPO	CPC	RTO	Professional Advisors
Months to obtain listing	8	8	8	6
Expected months to obtain listing	5	5	4	n/a

The overall length of time required to complete a listing on the junior exchange translates into significant opportunity cost risk. The cause of this risk can be analyzed into separate parts: the need to satisfy external requirements (including regulatory requirements) and the level of internal preparedness.

Other research in this area has compared the length of time it takes regulators in Canada and the U.S. to complete their review of submitted prospectuses. Using CVMQ data, Suret and Carpentier found that the average period for issuers to obtain a final decision from securities regulators in Canada was often less than the average period the U.S. Securities and Exchange Commission took to issue a final decision.[47] Based on this information, it is possible to conclude that opportunity cost risk is lower in Canada with its multiplicity of regulators than in the U.S. with its national regulator, and that a single regulator is not inherently better placed to reduce opportunity cost risk.

(c) *Case Studies*

For three initial public offerings, we analyzed transaction costs, compliance costs, opportunity cost risk and incremental employee-days. We found that:

- Incremental transaction costs arising from the existence of multiple securities regulators were in all instances immaterial to the case study participants.

- Case study participants could not yet quantify ongoing incremental compliance costs arising from their decision to list their securities on a stock exchange. The reason for this is that companies that have recently listed their securities are still in the process of organizational change for the purpose of satisfying their new regulatory requirements, and therefore any estimate of future incremental costs will be highly uncertain. However, we do not expect future incremental costs to be material;

[47] Suret and Carpentier, *supra* note 40 at 45-48.

- The existence of multiple securities regulators may impose a high opportunity cost risk on issuers that are listing their securities on an exchange. It is of critical importance that companies complete their offering within a market window. Each of the case study participants incurred a minimum of five working days delay to their transaction. This number was higher where regulators opted out of MRRS;

- Opportunity cost risk crystallized for one case study participant. The issuer decided to forego an opportunity for growth due to regulatory obstacles arising from a non-principal regulator which would have resulted in a significant delay to the IPO; and

- Incremental employee-days incurred by case study participants were not significant. Further, case study participants did not incur in excess of one and a half incremental business days in the preparation, review, and filing of preliminary and final prospectuses.

(i) Transaction Costs

We analyzed transaction costs both in terms of the individual line items of incremental costs and total incremental costs incurred by firms engaging in IPOs of their securities.

Incremental filing fees

Incremental filing fees arising from the existence of multiple securities regulators were in all instances immaterial to the case study participants.

Incremental legal and professional fees

Incremental legal and professional fees arising from the existence of multiple securities regulators were in all instances immaterial to the case study participants.

Incremental internal costs

Incremental internal costs arising from the existence of multiple securities regulators were in all instances immaterial to the case study participants.

Total incremental costs

Total incremental costs arising from the existence of multiple securities regulators averaged five basis points of the gross proceeds raised, and were therefore in all instances immaterial to the case study participants.

Due to the small population of case study participants, we cannot determine whether the level of costs incurred is typical of an IPO. With a materiality threshold of ½ of 1% of gross proceeds, however, incremental costs for other market participants would need to increase in percentage terms by a factor of ten before such costs became material.

(ii) Compliance Costs

A firm that obtains a listing on a stock market will typically incur ongoing compliance costs in order to satisfy regulatory requirements related to maintaining the firm's listing in good standing. These ongoing costs can include legal and professional fees, internal compliance time, printing costs, and filing and SEDAR fees.

While identifying the principal sources of future ongoing compliance costs is relatively straightforward, estimating future incremental ongoing compliance costs arising from the existence of multiple securities regulators entails significant uncertainty. Indeed, case study participants generally identified the sources of incremental costs but could not attach an expected value to those incremental costs.

Absent any estimates of future ongoing incremental compliance costs, we can assess the probability of such costs becoming material. For example, if we use an IPO that raised $100 million as an example, and hold the value of that capital raised constant into the future, then incremental costs would need to breach a threshold of $500,000 (being ½ of 1%). Assuming an average hourly rate of $300, this would translate into 208 days of a lawyer's time. The amount of incremental internal time would be significantly higher. We have therefore concluded that ongoing incremental compliance costs are likely to be immaterial.

Additionally, it is common for issuers to raise additional capital in the market in future years, the effect of which should not be to increase the existing level of incremental compliance costs, i.e. compliance costs are relatively fixed. The materiality of incremental compliance costs should therefore be diluted given the increased capital base those costs support.

(iii) Opportunity Cost Risk

Our case study participants emphasized the importance of timing to the success of their IPO's. A "market window" is identified and milestones required to successfully complete an IPO are determined by working back from that window. One of the risks associated with missing a market window is the deferral or outright cancellation of the IPO. A deferral or cancellation can seriously and adversely affect an issuer insofar as the planned IPO would have featured prominently in the issuer's existing business strategy. Business plans that had been intended to follow the IPO would be completely ruined.

With respect to the impact of the multiplicity of regulators, we received the following feedback:

- Ten working days are budgeted for the principal regulator;
- Five working days are budgeted for the non-principal regulators to either affirm or opt out of the MRRS process; and
- Several working days are budgeted as a contingency in the event of "slippage" in receiving feedback from the principal regulator or opt-outs on the part of non-principal regulators.

We received some feedback to indicate that some project milestones were brought forward (i.e. the schedule was made tighter) as a result of incremental regulatory requirements and not non-regulatory, commercial considerations.

In each case study, participants incurred a minimum incremental delay of five working days waiting for non-principal regulators to either affirm or opt out of the MRRS process. Where progress towards completion of an IPO is smooth, these budgeted incremental days may not cause companies to miss market windows. However, timetables can slip for a variety of reasons, and therefore these incremental days represent a real risk to companies listing their shares on an exchange for the first time. One of our case study participants also experienced a further incremental delay of three calendar days as a result of one regulator opting out of and subsequently opting back into the MRRS.

There was an additional instance of opportunity cost risk that crystallized, and thus adversely affected one of the case study participants. During the course of the IPO, an opportunity for additional growth became available to the issuer, which it pursued. The issuer ultimately abandoned the opportunity largely, though not exclusively, as a result of obstacles arising from non-principal regulators.

Finally, we received feedback that indicated the MRRS process does not necessarily operate where some but not all securities commissions are closed for statutory holidays. While the principal regulator remained open, others were closed and therefore could not technically affirm the principal regulator's approval of the prospectus. Given the potentially serious consequences to the issuer, its advisors called the relevant staff at those commissions at home to request their affirmation.

We can also offer some further anecdotal observations of issues that may have negatively impacted the case study participants. These events further emphasize the importance of achieving a market window:

- The war in Iraq;

- Speculation about further terrorist strikes, which negatively affected market confidence; and

- The release of adverse results of companies whose results were perceived to be correlated with the prospects of the issuer.

Circumstances such as these are outside the issuer's control. They vary in terms of predictability and, consequently, where events occur unexpectedly, an incremental delay of even one day can adversely affect the offering.

(iv) Incremental Internal and External Employee-days

Case study participants uniformly reported significant investments in employee and advisor time in the course of completing their IPOs. The amount of time generally exceeded one year of employee-days. At the upper end, one case study participant reported approximately

110 internal and 335 external employee-days, though this was in some measure due to the complexity inherent in the particular circumstances.

Case study participants did not incur significant incremental employee-days in completing their IPOs because of the current regulatory structure. The highest reported were 37 incremental employee-days. Assuming approximately 22 business days per month, this is less than two months of incremental employee work which is unlikely to result in overstaffing. These results are consistent with the immateriality of incremental internal transaction costs found above.

Incremental employee-days did not translate into significant incremental delays in transaction execution. The existence of multiple securities regulators resulted in the delay of one business day in filing the preliminary prospectus, and one half-business day in respect of the final prospectus (though the latter is influenced by the number and substance of comments received from securities regulators). As noted above, market timing is critical to IPOs and the incremental risk associated with the existence of multiple securities regulators appears to have been kept to a minimum, generally speaking.

(d) *Regulatory Models*

In this section, we describe the potential cost savings in the IPO process of moving to an alternative regulatory model.

(i) Passport System

The passport system of regulation may not eliminate incremental compliance costs. While case study participants could not estimate incremental compliance costs, it is clear that some possibly material costs would be incurred. Clearly, compliance with only one regulatory regime under the passport system will reduce incremental compliance costs, though their elimination will depend on the particular passport regime that may be implemented. We note, for example, that certain incremental compliance costs will likely remain under the passport system such as fees stemming from periodic fees payable for continuous disclosure filings and that these will need to be paid in every province in which the issuer is a reporting issuer. We understand that more detail relating to the passport system is being developed and that provincial ministers are targeting the release of an action plan that would more fully describe the passport system and the steps needed to implement in the fall of 2003.

A robust passport system of regulation should eliminate the incremental opportunity cost risk that case study participants reported to us. Specifically, the approval of a prospectus by host regulators is deemed to have occurred at the time the primary regulator approves the prospectus. Therefore, once the principal regulator has indicated its approval of the issuer's disclosure documents, non-principal regulators could not *ex post* raise objections to the transaction or to the issuer's disclosure relating to the transaction. Therefore, issuers would not budget for the incremental time that is required under the MRRS process. The risk of missing market windows that arises from the existence of multiple securities regulators would therefore be eliminated.

Further, issuers under the passport system of regulation would not be subject to events (such as the effect of public holidays) which may cause MRRS to fail to operate as broadly intended and adversely affect the timing of an IPO.

(ii) Uniform Securities Legislation

A pure USL should reduce ongoing incremental compliance costs, though whether they are completely eliminated will depend on how the USL regime operates, the level of harmonization among the jurisdictions, the number of "local rules" and inter-commission delegation. As under the passport system, the extent of harmonization among the jurisdictions is a crucial determinant of costs. To raise but one example, some jurisdictions currently require the filing of material change reports while others require the filing of a press release only. Other jurisdictions have no material change reporting requirements. While the practice is to file the material change report in every jurisdiction where the issuer's SEDAR profile indicates it is a reporting issuer, inconsistent requirements across jurisdictions and accompanying fees in certain instances can give rise to incremental compliance costs that would be eliminated under a purely harmonized regime.

The extent to which opportunity cost risk may be reduced will depend on the manner in which MRRS would operate under USL. The following issues are relevant to our analysis:

- Whether any incremental time will be required by non-principal regulators to affirm the MRRS decision of the principal regulator; and

- Whether non-principal regulators will be able to opt out of the MRRS process.

Reducing opportunity cost risk depends on reducing the time delays currently imposed on issuers by the current regulatory regime. As a starting point, we find that opportunity cost would not be significantly reduced if USL does not incorporate a mandatory MRRS process into its operation. If a mandatory MRRS process (i.e. one without the ability to opt out) is incorporated into USL, then opportunity cost risk reported by case study participants should be eliminated.

Where a mandatory MRRS is not incorporated into USL, we assumed that a voluntary MRRS process would nevertheless continue. The scope for a reduction in opportunity cost risk would depend on how a voluntary MRRS process would operate. Where a voluntary MRRS process reduces the current five working days that non-principal regulators have to consider the decision of the principal regulator *and* attenuates all regulators' ability to opt-out of MRRS, then opportunity cost risk would be reduced.

However, if the MRRS process were to operate under a USL regime in a manner similar to the way it operates under the current regime, there may not be any reduction in opportunity cost risk. First principles suggest that under a USL regime, opt-outs permitted under the current regime, would only be beneficial if the principal regulator manifestly erred in the application of the law. Restricting the already infrequent use of opt-outs may be achieved if regulators did not have the ability to opt back into MRRS. A voluntary MRRS process similar to the current one would not address the issue of non-substantive differences in the interpretation of regulation, and

consequently a USL regime may still operate to the detriment of issuers due to the risk of opt-outs and separate hearings.

Finally, a robust USL regime should eliminate the type of opportunity cost risk experienced by one case study participant which contributed in large measure to the foregoing of a commercial opportunity that arose during the IPO process.

(iii) Single Regulator

In keeping with our focus on costs and bearing in mind the existence of multiple regulatory objectives, a single regulator's ability to reduce the gross compliance costs incurred by issuers will depend on a variety of factors, some of which are not unique to the single regulator model. These factors include: the complexity of ongoing regulation; the number of separate filings it will require from issuers; and the amount of direct costs imposed on issuers (e.g. periodic fees incurred by issuers to cover costs of compliance). From a cost perspective, a single regulator should avoid imposing additional compliance costs where these are material or become material in aggregate.

Opportunity cost risk would similarly only be reduced if a single regulator could reduce the time issuers incur to satisfy regulatory requirements without adversely affecting investor protection. Feedback that we received suggests that a minimum of 15 working days are budgeted by issuers under the current regime in order to obtain regulatory approval. Given that these 15 working days are made up of 10 working days budgeted for the principal regulator and the balance for non-principal regulators, a single regulator could operate under the timetable existing for the principal regulator, i.e. 10 working days, arguably without prejudicing investor protection. Therefore, all else being equal, issuers would "save" a minimum of five working days, and consequently reduce opportunity cost risk.

Finally, we have not formed an opinion whether the opportunity cost risk that adversely affected one case study participant would continue under a single regulator. As in the other models, the substantive law will determine what effect significant commercial activity would have on an issuer's IPO, and this cannot be known in advance.

4. Exempt Market Transactions

(a) *Background*

Exempt distributions generally take one of three forms:

1. The most common type of exempt distribution occurs when the transaction falls squarely within the terms of an exemption. The issuer would, in many cases, retain counsel outside of the issuer's provincial or territorial jurisdiction in the process of completing the offering.

2. Another type of exempt distribution occurs when the transaction does not meet the requirements of pre-existing exemptions and the issuer must apply to regulatory authorities for an exemption from the prospectus requirement.

3. The third is a hybrid of the first two: the transaction meets the terms of the exemption in certain jurisdictions but not in others. In this case, the issuer would need to make applications to some, but not all, jurisdictions for an exemption from the prospectus requirement to proceed. This type of distribution can be common in a regime with multiple regulators and an unharmonized regulatory regime.

Historically, the exempt market has been one area in which the absence of harmonization among provincial and territorial regulators has been conspicuous. Each jurisdiction promulgated exemptions from the prospectus requirement that were not necessarily consistent with exemptions in other jurisdictions. As a result, an issuer seeking to complete an exempt offering needed to ensure that the offering fell within one of the permitted exemptions in each jurisdiction. If the exemption happened not to be harmonized, the issuer may have needed to make an application for an exemption order from the particular regulator whose regime was not harmonized. The inability of certain jurisdictions (such as Ontario) to issue blanket rulings has exacerbated this problem since exemption orders granted once cannot be relied on by other issuers as precedent.

Over the past 10 years, significant changes have occurred in the regulation of the exempt market.[48] On a national level, two of the most important of these reforms have been:

- Multilateral Instrument 45-102 Resale of Securities, which introduced uniform hold periods to replace local hold periods in the various provincial statutes;[49] and

- Multilateral Instrument 45-103, which introduced uniform exemptions from the prospectus requirement in almost all provincial jurisdictions except Ontario and Québec.[50]

Despite these two important pieces of legislation, the fact remains that exemptions from the prospectus requirements are not harmonized across Canada. This lack of harmonization adds time and expense for issuers, as they must make applications for discretionary relief.

Further, even if the substantive law is harmonized and exemptions are made uniform across the country, issuers will still need to deal with 13 regulators, i.e. they will pay filing fees to each regulator. They will also be responsible for professional fees associated with retaining legal counsel in each jurisdiction. For any exempt offering in more than one jurisdiction, the issuer will retain counsel to review the legislation in every jurisdiction in which it seeks to offer the securities.

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48 Some of these are discussed at length in the Five Year Review Committee Final Report, *supra* note 6 at 134-141.

49 (2001), 24 OSCB 7029.

50 Jurisdictions party to the instrument include B.C., Alberta, Saskatchewan, Manitoba, Nova Scotia, Prince Edward Island and Nunavut. Newfoundland will be adopting a local rule that is similar to 45-103 and the Northwest Territories will be adopting it as an amendment to an existing blanket order. As New Brunswick and the Yukon do not have rule-making authority, they are unable to adopt the rule but they have indicated that they will consider exemptions on a case-by-case basis considering 45-103.

(b) *Review of Existing Literature*

In its discussion of the exempt market, the CRR concluded that:

- Under a single regulatory model, instead of the current system, the average potential savings per exemptive relief application was $1,124. However, this average includes the 60% of respondents who thought there would be little or no savings;[51]

- Based on the sample of responses received in connection with the CRR, the percentage of private placements that are made in one, two or three, or four or more jurisdictions are 30%, 42%, and 29%, respectively.[52] It is possible that participants may have accessed a broader market (i.e. raised capital in more jurisdictions) had there been regulatory consistency. To the extent that regulatory duplication and inconsistency made it more difficult to tap a broader market, costs include those associated with the smaller pool of capital available and a higher cost of that capital;

- Regulators also have a fixed amount of time to decide whether or not to comply with another jurisdiction's decision to grant exemptive relief.[53] In the best-case scenario, issuers must still wait while that fixed timetable expires. This waiting period does not result in an optimal use of time. In the worst-case scenario, any regulator in whose jurisdiction the exempt activity is to occur can reject the other regulator's granting of exemptive relief, resulting in an even longer delay for issuers attempting to access the market.

The CRR did not quantify the incremental costs associated with the regulatory regime. We have attempted to do so by quantifying the incremental costs associated with exempt market transactions to discern the broad effects that our regulatory regime has on market participants. Specifically, we focused on the accredited investor exemption, an exempt distribution pursuant to an offering memorandum and an exemption application for a collective investment vehicle. (Incremental regulatory costs associated with other exempt market activity, such as rights offerings or stock option plans, remain outside the scope of this report.)

(c) *Case Studies*

For three exempt market transactions, we analyzed transaction costs, opportunity cost risk and incremental employee-days. We found that:

- Incremental transaction costs arising from the existence of multiple securities regulators were in all instances immaterial to our case study participants. This is consistent with the CRR finding of potential savings of $1,124 per exemptive relief application. We note, however, that incremental costs may fall disproportionately on issuers engaging in smaller exempt distributions;

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51 CRR, *supra* note 22 at 28.

52 *Ibid* at 29.

53 *Ibid* at 33.

- Case study participants did report opportunity cost risk arising from the existence of multiple securities regulators. One case study participant was exposed to opportunity cost risk which, if it had crystallized, would have resulted in fewer subscribers to its exempt distribution, and another incurred a five business day delay in its transaction due to MRRS; and

- Incremental employee-days incurred by case study participants were not substantial, though one participant incurred additional incremental employee-days as a result of the crystallization of compliance risk arising from the existence of multiple securities regulators, which was revealed by the normal due diligence procedures that precede capital market transactions.

(i) Transaction Costs

Incremental filing fees

Incremental filing fees arising from the existence of multiple securities regulators were in all instances immaterial to the case study participants.

Incremental legal and professional fees

Incremental legal and professional fees arising from the existence of multiple securities regulators were in all instances immaterial to the case study participants.

Incremental internal costs

Incremental internal costs arising from the existence of multiple securities regulators were in all instances immaterial to the case study participants.

Total incremental costs

In the three transactions that we examined, total incremental costs arising from the existence of multiple securities regulators averaged three basis points of the gross proceeds raised, and were therefore in all instances immaterial to the case study participants.

Due to the small number of case study participants, we cannot determine whether the level of costs incurred is typical of an exempt distribution. We note, however, that, in common with the conclusions drawn from registrant case study participants, incremental costs fall disproportionately on issuers engaging in smaller exempt distributions. For example, the fee payable by the smallest case study participant to one non-principal regulator *alone* represented a higher percentage of incremental costs relative to the size of the transaction than the percentage of *aggregate* incremental costs relative to the size of the transaction of the larger case study participants. Thus the current regulatory regime may therefore impose a competitive disadvantage on issuers raising relatively small amounts of capital in the exempt market.

With a materiality threshold of ½ of 1% of gross proceeds, however, incremental costs for other market participants would need to increase in percentage terms by a factor of 17 before such costs became material.

Though the incremental transaction costs reported to us by case study participants were immaterial, we note that the cost of capital raised in an exempt distribution is higher, all else being equal, for debt capital than equity capital, and higher again for shorter duration debt capital than longer duration debt capital. The reason for this is that incremental transaction costs will be broadly similar at every level of capital raised regardless of the security issued. The current regime may therefore disproportionately affect issuers of debt finance.

(ii) Opportunity Cost Risk

Securities regulators assert jurisdiction on the basis of residence of investors among other things. However, in our discussions with issuers and their counsel, we found that firms raising capital will target investors regardless of the jurisdiction in which they reside. Generally, they will not seek to avoid certain jurisdictions or restrict the number of jurisdictions. Rather, they will incur incremental transaction costs in order to raise the capital they require.

An additional consideration is the need to fix a transaction date. Once this transaction date is fixed, changing it will often entail additional risk, and therefore firms need to assess the benefits of delay against the additional risk arising from the delay.

We received feedback from one case study participant that was required to apply for exemptions in only one of the seven jurisdictions in which it intended to raise capital. None of the other jurisdictions needed to grant an exemption given their existing exempt market regime. When the firm applied for the exemptions, it did so upon the belief that it had provided sufficient time to obtain the exemptions it sought. However, the practice of the commission involved was to consider certain applications for exemptive relief on a weekly basis, and the applications had missed that window. As a result, the firm needed to decide whether to delay its settlement date or bypass the investors it had identified in that jurisdiction. It decided to bypass the jurisdiction, and consequently raise less capital, rather than assume the additional opportunity cost risk that would have been imposed had the exemptions not been granted.

Ultimately, the exemptions were granted and the firm did not lose the investors in that jurisdiction. However, the firm was exposed to opportunity cost risk due to the lack of harmonized regulation relating to exempt distributions together with the commission's practice of considering those applications on a weekly basis rather than immediately upon receipt.

Another case study participant applied for exemptive relief in the four jurisdictions in which it planned to raise capital. This participant expressed concerns with the time limits contained in National Policy 12-201 dealing with the MRRS for exemptive relief applications.[54] Under the policy, a non-principal regulator has five business days from the receipt of the principal decision documents to confirm whether it is opting out of MRRS for that application.[55] Staff of a non-principal regulator have seven days to review the application and to forward comments containing substantive issues which could cause the non-principal regulator to opt out

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[54] (2002), 25 OSCB 4457.

[55] *Ibid* at s. 8.1. We note that under s. 6.2 of the same policy, staff of a non-principal regulator have seven days to review the application and to forward comments containing substantive issues which could cause the non-principal regulator to opt out of the MRRS. Yet this time limit seems inconsistent with the five-day time period stipulated in s. 8.1.

of the MRRS.[56] The principal regulator then has an unlimited amount of time to complete its review and send its MRRS decision to the non-principal regulators.[57]

This analysis suggests one measurable incremental delay and another possible delay. The measurable incremental delay, and hence an increase in opportunity cost risk, is the five business days the non-principal regulators have to opt out of the principal regulator's MRRS decision. There may be a further increase in opportunity cost risk if the principal regulator completes its review within the initial seven days that non-principal regulators have to review the applications, and hence they wait for that review period to expire rather than promptly rendering its decision.

This case study participant therefore incurred a minimum incremental five business day delay in receiving its exemption (no non-principal regulator opted out). These five days represented a significant portion of the time it incurred between the submission of the applications for exemptive relief and the receipt of the regulator's decision.

(iii) Incremental Internal and External Employee-days

The number of employee-days incurred due to the existence of multiple securities regulators varied from five (where no applications for exemptive relief were required) to nine (where applications for exemptive relief were required). It may seem counter-intuitive for there to be incremental employee-days incurred where an exempt distribution does not require any applications for exemptive relief. However, incremental costs do arise as a result of inconsistencies in exemptions. For example, a single transaction may fall under the "Accredited Investor Exemption" in B.C. and the "Sophisticated Purchaser Exemption" in Québec. Legal advisors will be required to consult the legislation and practice of both jurisdictions in order to be able to confirm the availability of the separate exemptions to their client. While arriving at decisions in this regard will require fewer employee-days than transactions requiring applications for exemptive relief, it does give rise to incremental costs nonetheless. This conclusion is supported by the responses we received from our case study participants.

The number of incremental employee-days required to complete the exempt distribution was not substantial and, as noted above, did not produce material incremental costs. Further, these incremental employee-days ran concurrently with other non-incremental work, and consequently no additional business days were required to complete the transaction.

These responses exclude the number of employee-days required by one case study participant to bring regulatory compliance up-to-date after due diligence prior to the exempt distribution revealed that regulatory filings were not fully up-to-date. Strictly speaking, while these employee-days were not incremental to the transaction *per se*, we believe it is appropriate to comment on them because these employee-days were incurred in respect of filings due in one jurisdiction only (i.e. the incremental compliance risk borne by the case study participant may, under different circumstances, have resulted in a delay in executing its transaction).

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56 *Ibid* at s. 6.2. This time limit seems inconsistent with the five-day time period stipulated in s. 8.1.

57 *Ibid* at s. 6.4.

(d) *Regulatory Models*

In this section, we describe the potential cost savings in exempt market transactions of moving to an alternative regulatory model. We begin by reviewing incremental costs associated with the current system.

(i) Passport System

The proposed passport system of regulation does not currently provide detail regarding how a national exempt offering can be completed under the system. We understand that there are two broad alternatives: either exemptions will be harmonized across jurisdictions or each jurisdiction will recognize the exempt market regime of another so that a market participant would have to comply with the rules and laws of its primary jurisdiction only in order to offer securities in all jurisdictions. While we have generally considered in this report how a robust passport system of regulation may operate, our findings here are more speculative given the uncertainty surrounding the way in which the passport system will accommodate exempt market offerings.

The passport system of regulation may not eliminate any competitive disadvantage imposed upon issuers raising smaller amounts of capital on the exempt market. While incremental legal fees should be eliminated, regulatory fees may not be. As noted above, regulatory fees are relatively more significant (though strictly still immaterial) and therefore such issuers may still be disadvantaged under the passport model.

The passport system of regulation would reduce the opportunity cost risk borne by issuers. The reason is that the approval of an exempt distribution by host jurisdiction is automatic where the exempt distribution is permitted either by the primary jurisdiction's legislation or exemptive relief is granted by the primary regulator.

With respect to the three scenarios of exempt distribution noted earlier, it is the second and third scenario that are more likely to impose opportunity cost risk (the first requires incremental advisor time which often runs concurrently to other, non-incremental work). We note specifically that:

- Issuers need not apply to all jurisdictions for exemptive relief from the prospectus requirement (second scenario). The granting of exemptive relief by the primary regulator is sufficient; and

- Unharmonized legislation governing exempt distributions whereby exemptive relief is required by some but not all jurisdictions (third scenario) should again be irrelevant. An important caveat is that a less robust passport model may not reduce opportunity cost risk if regulators were unwilling to recognize exemptions unavailable to issuers under its jurisdiction.

A robust passport system of regulation should eliminate the incremental opportunity cost risk that is incurred under MRRS. In common with IPOs, transaction approval by host regulators is deemed to have occurred at the time the primary regulator grants its approval. Therefore,

issuers would not incur the incremental five business days that exists under the current MRRS process.

Consistent with our analysis of opportunity cost risk, we believe that a robust passport system of regulation would reduce the incremental internal and external employee-days that case study participants reported to us. The principal cause of this reduction would be the elimination of the need to review securities legislation pertaining to multiple jurisdictions.

Finally, though not specific to exempt distributions, we note that compliance risk should be reduced under the passport model. One case study participant discovered defects in its regulatory record. Such defects can be discovered in the course of a due diligence exercise common not only in the context of exempt distributions, but also in the context of takeover bids. The risk of delays to a transaction due to the crystallization of compliance risk arising from the need to comply with multiple securities regulators would be reduced or eliminated if an issuer was required to answer to one regulator only.

(ii) Uniform Securities Legislation

A USL regime may not eliminate any competitive disadvantage imposed upon issuers raising smaller amounts of capital on the exempt market. The extent to which incremental legal fees would be reduced or eliminated would depend on whether this model permitted "local rules". Further, regulatory fees may not be reduced. Smaller issuers may therefore not experience a perceptible reduction in incremental costs.

Above, we outlined the three general forms of exempt market transactions: transactions that fall squarely within the terms of an exemption, transactions that do not meet the requirements of pre-existing exemptions and the issuer must apply for an exemption from the prospectus requirement; transactions that meet the terms of the exemption in certain jurisdictions but not in others.

A USL regime may reduce opportunity cost risk under the second type of exempt distribution. Important considerations in reducing this type of risk are whether, under USL, the MRRS process continues on a voluntary or a mandatory basis and the extent to which opt-outs are permitted and utilized by securities regulatory authorities.

Under pure USL, opportunity cost risk under the third scenario should be completely eliminated provided that "local rules" do not exist that impede the operation of nominally harmonized legislation. Absent local rules, there would be no need for applications for exemptive relief in some but not all jurisdictions, and therefore issuers would not encounter incremental delays in completing their transaction. Incremental internal and external employee-days should also be eliminated. Yet we note that under the current version of USL, all exemptions are not completely uniform across the country despite the introduction of National Instrument 45-103. The absence of complete uniformity will increase issuers' costs.

It is less clear that incremental compliance risk would be reduced. Again, this would depend on the level of harmonization of the mechanics of compliance. For example, we note that CSA structural initiatives such as MRRS, SEDAR and SEDI have contributed to the harmonization of securities laws but in many cases, substantive laws in each of the jurisdictions

continue to differ as does the application of otherwise harmonized laws. Thus, generally speaking, it is accurate to say that methods of compliance across jurisdictions also differ. All compliance mechanisms would need to be harmonized before such incremental risk could be completely eliminated.

(iii) Single Regulator

A single regulator has strong potential to reduce or eliminate competitive disadvantage imposed upon smaller issuers raising capital in the exempt market. For example, it should be straightforward for a single regulator to reduce the gross costs imposed on smaller issuers by reducing the fees payable by smaller issuers seeking exemptive relief. A single regulator could also simplify the regulatory burden imposed on smaller issuers which should result in lower gross legal fees.

A single regulator may reduce or eliminate opportunity cost risk under the second and third scenarios as only a maximum of one application for exemptive relief would be required for the contemplated transaction. (Multiple applications may nevertheless be required if more that one regulatory provision were triggered, though these multiple applications would still be made to one regulator.) This uncertainty also affects the extent to which incremental internal and external employee-days would be incurred by the issuer.

The extent to which issuers would benefit from a reduction or elimination of opportunity cost risk would depend on the breadth of exemptions defined in legislation and the responsiveness of the regulator to applications for exemptive relief. With respect to regulatory responsiveness, we note that under the current regime the principal regulator has an indefinite period to complete its review of applications for exemptive relief. The single regulator model may reduce opportunity cost risk by imposing a reasonable limit on the amount of time it has to consider such applications. Given the current limit of five business days given to non-principal regulators, there is a *prima facie* case for saying that a reasonable time limit could not exceed those five business days.

On the other hand, we note that issuers would not have the option to disregard a single regulator in the way that one case study participant contemplated doing with regards to a provincial securities regulator during its distribution. If a single regulator refused an application, the issuer would be forced either to amend the terms of its transaction or to produce a prospectus. Finally, we note that incremental compliance risk would be completely eliminated under the single regulator model.

5. Acquisition Transactions

(a) *Background*

Until recently, provincial and territorial jurisdictions had similar (but not necessarily identical) legislation governing take-over bids with the exception of the Province of Québec. The Zimmerman amendments permitted take-over bids to be commenced by advertisement instead of mailings and extended the minimum period during which a take-over bid must remain

open for acceptance from 21 to 35 days.[58] Because Québec did not adopt the Zimmerman amendments, two regimes operated concurrently in take-over bids that involved offeree shareholders in Québec and another Canadian jurisdiction. As a result, offerors that sought to complete a take-over bid across the country frequently sought relief from the requirements in Québec rather than opting to comply with two different regimes.

On June 27, 2003, Québec adopted the Zimmerman amendments. The takeover bid rules are now substantially similar across the country. There remain two important differences, however. First, if an offeror intends to commence a take-over bid in Québec, an advertisement must be placed in a daily French-language newspaper that is in general circulation in Québec. Secondly, if the bidder notifies shareholders of a change to its bid (whether as a result of a variation in the terms of the bid or of a material change), under the *Securities Act* (Québec), an updated directors' circular must be sent to securityholders within five days following the notice of change. Elsewhere in Canada, directors do not have this five-day period but must deliver a notice of change "forthwith."

Two jurisdictions in Canada have rules relating to the treatment of minority shareholders in certain acquisition transactions. Under OSC Rule 61-501 and Québec's Q-27, issuers attempting to complete an insider bid must, among other things, complete a valuation unless an exemption is available.[59] The existence of these two rules means that the securities laws applying to certain acquisition transactions are not harmonized with the rest of Canada. However, we chose to exclude from our analysis costs involved in complying with these rules because the incremental costs associated with the rules are not likely to be high in at least two of the models (USL and single regulator).

We took into account incremental costs associated with filing disclosure documents (such as circulars, material change reports and notices of change or variation) and exemption applications in 13 jurisdictions. We also considered costs of hearings in contested take-over bids and discussed these costs with case study participants. Our view is that, generally speaking, there will be no material incremental costs associated with such hearings where they are held in one as opposed to multiple jurisdictions. Indeed, regulators have taken the view that hearings in a take-over bid fall under MRRS and therefore a lead regulator can be appointed to hear and decide the issue under dispute.

We are aware that the regulation relating to takeover bids is generally harmonized and therefore may not give rise to significant incremental costs as may arise in an examination of other acquisition transactions (such as arrangements). However, upon being asked to examine takeover bids by the WPC, we agreed to do so because these transactions comprise a significant portion of capital market activity relating to acquisitions and because unlike arrangements and other acquisition transactions, they fall more squarely under the purview of securities regulation.

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58 Zimmerman, "Report of the Committee to Review Take-Over Bid Time Limits" (1996).

59 Rule 61-501 Insider Bids, Issuer Bids, Going Private Transactions and Related Party Transactions (2000) 23 OSCB 2719; Policy Statement Q-27 Protection of Minority Securityholders in the Course of Certain Transactions.

(b) *Case Studies*

For three acquisition transactions, we analyzed transaction costs, opportunity cost risk, and incremental employee-days. We found that:

- Incremental transaction costs arising from the existence of multiple securities regulators were in all instances immaterial to the case study participants;

- Case study participants did report opportunity cost risk arising from the possibility of hearings in which multiple securities regulators may have participated; and

- Incremental employee-days incurred by case study participants were not substantial for at least two case study participants. The other case study participant may have incurred incremental internal employee-days that were sufficient to give rise to overstaffing.

(i) Transaction Costs

Incremental filing fees

Incremental filing fees arising from the existence of multiple securities regulators were in all instances immaterial to the case study participants.

Incremental legal and professional fees

Incremental legal and professional fees arising from the existence of multiple securities regulators were in all instances immaterial to the case study participants.

Incremental internal costs

Incremental internal costs arising from the existence of multiple securities regulators were in all instances immaterial to two of the case study participants. The other case study participant estimated that internal costs were 15-25% higher due to the existence of multiple securities regulators. However, this participant was unable to estimate the value of these incremental internal costs and prevented us from definitively assessing their materiality relative to the value of the transaction.

In the other areas of securities regulation examined in this Report, case study participants typically reported that the hourly expense of external legal advisors is higher that the hourly expense of internal time. Applying this approach to this participant, we assumed that incremental internal costs could not exceed incremental legal fees which we found to be immaterial. We therefore find that incremental internal costs to be immaterial to this case study participant, consistent with our findings above.

Aggregate incremental costs

In the three transactions that we examined, aggregate incremental transaction costs (including a prudent estimate for incremental internal costs) arising from the existence of multiple securities regulators were in all instances immaterial to our case study participants.

Aggregate incremental transaction costs averaged seven basis points of the gross proceeds raised on a weighted basis. Due to the small number of case study participants, we cannot determine whether the level of costs incurred is typical of an acquisition transaction. With a materiality threshold of ½ of 1% of gross proceeds, however, incremental costs for other market participants would need to increase by a factor of seven before such costs became material.

Though total incremental transaction costs were immaterial, the weighted average of seven basis points masks a considerable variance in the responses we received. The highest reported total incremental transaction costs were 37 basis points of the gross takeover value, while the incremental costs of the two remaining transactions amounted to two basis points.

The legal advisors of the case study participant which reported the highest percentage of incremental costs stated that incremental costs are embedded within their legal work (e.g. the need to perform statutory reviews to ensure local compliance and conduct applicable form checks) and therefore fees are typically increased by 15-25%. The approach taken by other case study participants was that, with a few exceptions such as certain differences between OSC Rule 61-501 and Québec Policy Q-27, the relatively harmonized legislation would not give rise to noticeable incremental transaction costs.

(ii) Opportunity Cost Risk

In common with other capital market transactions, acquisition transactions are often time sensitive. Offerors usually have targeted a specific window of opportunity within which they seek to complete the transaction. Delays experienced by hostile bidders can act to the detriment of those bidders as it gives the target company more time to seek a white knight or engage in other defensive actions. Conversely, delays can be beneficial to the target's shareholders as defensive measures taken by the target can lead to higher offers for the target's shares.

We also received anecdotal feedback that indicated that some targets in hostile takeovers exploit the fragmented regulatory regime to defend themselves against predators. One such tactic is to "forum shop" among jurisdictions to identify commissions that would be willing to conduct hearings on a particular issue and thereby delay the attempted acquisition. None of the case study participants had direct experience with such tactics, however. It appeared to us that regulators attempt to reduce duplication when a hearing arises in various ways such as by holding the hearing jointly.

One case study participant reported opportunity cost risk arising from the hearings that were held in respect of its transaction. While one regulator held the hearings, the company's legal advisors were concerned that other regulators may chose to participate in those hearings. Specifically, the opportunity cost risks that arise from single jurisdiction hearings in which multiple regulators participate include additional time not only to conduct the hearings but also

to address issues raised by non-principal regulators during the principal regulator's hearings. Our case study participant did incur incremental time in preparing for such an eventuality; however, the additional regulators ultimately chose not to participate.

(iii) Incremental Internal and External Employee-days

In common with our finding of immaterial incremental transaction costs, there was significant variance in incremental internal and external employee-days. In the case of one participant which found that the existence of multiple securities regulators increased costs by 15-25%, there was a commensurate increase in internal and external employee-days. However, this participant was unable to estimate total internal time, and therefore we have not been able to assess whether this participant was over-staffed but for the existence of multiple securities regulators. Given the immateriality of the costs, we do not expect that this case study participant was significantly over-staffed.

(c) *Regulatory Models*

(i) Passport System

The provincial ministers' Discussion Paper does not discuss takeover bids or how takeover bid regulation would be treated under the proposed passport system. However, a robust passport system of regulation that allowed an acquirer to comply only with the requirements of its home jurisdiction and allowed the acquirer to disregard entirely the requirements of the target's home jurisdiction should eliminate the risk of: (a) hearings in multiple jurisdictions; and (b) single jurisdiction hearings in which multiple jurisdictions participate. Such a system would further reduce and possibly eliminate the ability of targets in hostile acquisition transactions to engage in forum shopping in order to delay the acquirer. The latter component of opportunity cost risk would be eliminated if submissions could be made to the acquirer's principal regulator only.

Incremental internal and external employee-days would also be eliminated under such a system (subject to the uncertainty over forum shopping) since, for example, there would no longer be a need to perform statutory reviews to ensure local compliance and conduct applicable form checks. Therefore, the risk of overstaffing would be eliminated.

(ii) Uniform Securities Legislation

As noted above, acquisition transactions are relatively well harmonized under the current regulatory regime. Nevertheless, we have received feedback that issuers incur (immaterial) incremental costs and opportunity cost risk despite the high degree of harmonization.

With respect to opportunity cost risk, USL would reduce or eliminate transaction delays only if non-principal jurisdictions (however defined) do not have a right either to hold separate hearings or participate in the hearings held by the principal regulator. In other words, a mandatory MRRS process applied to takeover bids would be required to eliminate opportunity cost risk as mere harmonization of substantive law would not necessarily do so.

(iii) Single Regulator

A single regulator would eliminate the opportunity cost risk of hearings in multiple jurisdictions and single jurisdiction hearings in which multiple jurisdictions participate. However, the extent to which total opportunity cost risk would be reduced under the single regulator model would depend on the efficiency of the regulator in holding hearings, i.e. whether the hearings are held promptly and conducted in a time-efficient manner with decisions rendered in a timely manner.

Finally, targets in hostile takeover bids could not engage in forum shopping in order to delay the acquirer. From the perspective of the acquirer, a regulatory hearing is generally unwelcome as it has the effect of increasing its opportunity cost risk. Under the current regime, targets are able to approach multiple securities regulators in order to maximize the likelihood of a hearing being held, and therefore increase the probability of a successful defence against the hostile bid.

Acquirers would have a lower opportunity cost risk under the single regulator model. The single regulator model by definition restricts a target's opportunity to obtain multiple hearings as there is only one securities commission that it could approach. In other words, the target could not exploit a structure with numerous regulators in order to have multiple hearings on the same issue.

Glossary

"BCSC" means the British Columbia Securities Commission.

"CPC" means a Capital Pool Company, i.e. a company that possesses experienced management and capital, which can be used to acquire a small, capital-hungry firm that possesses upside potential.

"CRR" means the report entitled "Estimating the Incremental Costs of Multiple Securities Regulators in Canada" prepared for the IDA by Charles River Associates Canada Ltd. (2003).

"CSA" means the Canadian Securities Administrators.

"CVMQ" means the Commission des valeurs mobilières du Québec or the Québec Securities Commission.

"IDA" means the Investment Dealers Association of Canada.

"IPO" means initial public offering.

"Issuer" means a person or company who has outstanding, issues or proposes to issue, a security.

"MI 45-102" means Multilateral Instrument 45-102 *Resale of Securities*.

"MI 45-103" means Multilateral Instrument 45-103 *Capital Raising Exemptions*.

"MRRS" means the Mutual Reliance Review System embodied in National Policy 43-201 and National Policy 12-201.

"NRD" means the National Registration Database.

"OSC" means the Ontario Securities Commission.

"Registrant" means a person or company registered or required to be registered under a securities act.

"RTO" means a Reverse Take-over Bid, i.e. a private company that acquires the shares of a company already listed on the TSX Venture Exchange.

"SEDAR" means the System for Electronic Document Analysis and Retrieval.

"SPI" means a Special Purpose Issuer.

"SRO" means Self Regulatory Organization as defined in provincial securities legislation.

"Take-over bid" means an offer to acquire outstanding shares where the securities constitute, in the aggregate, 20% or more of the outstanding securities of that class of securities at the date of the offer to acquire.

"TSX" means the Toronto Stock Exchange.

"TSX study" means an unpublished study completed by the TSX on IPOs entitled "The Costs of Going Public on the Toronto Stock Exchange"

"TSX Venture Exchange" means Canada's national exchange for venture class securities.

"USL" means uniform securities legislation, a concept proposal published by the CSA.

"WPC" means the Wise Persons' Committee.